THE AMERICAN AIRLINE INDUSTRY AND SOUTHWEST AIRLINES

Introduction

The domestic airline industry in the USA has been characterized by intense rivalry and low profit margins. Within the industry, however, there have been differences in terms of profitability, for example Southwest Airlines was the only major US carrier in 1990 to show a net profit based solely on operations. This paper will first analyze the airline industry as a whole, before turning to Southwest to examine what factors give it a competitive advantage. The future of Southwest will then be discussed, both in terms of potential threats to the airline and in terms of its overall strategy.

Industry Analysis

Since the Airline of Deregulation Act of 1978, the airline industry has faced a number of years low profitability. Why? In order to answer this question, Porters Five Forces model will be used.

Rivalry

The degree of rivalry that exists within an industry will affect its overall profitability. One of the main factors affecting rivalry is market concentration. By 1989, the eight largest carriers had a combined market share of 92%, but no single airline dominated. Smaller “upstart” airlines such as Reno Air helped to increase competition on certain routes through price undercutting. It should be noted, through, that there are differences throughout the US in the extent of airline coverage. Rivalry tends to be greater on those routes served by many carriers.

Other factors affecting rivalry include high fixed costs, excess capacity, low differentiation, slow growth, and high exit costs. Although airplanes were described as “marginal costs with wings” in the 1970s, in practice, fixed costs of airlines are not low. On any flight, for example, there are the costs of fuel, pilots, flight attendants, ground staff, and the airline depreciation/leasing. In order to recover these fixed costs, airlines will want to maximize

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1 CAB Chairman Alfred Kahn in HBS case
their load factor by increasing revenue passenger miles, (RPMs). Given that there is currently excess capacity on many routes, intense price competition to attract passenger often results. Low differentiation between airlines and low switching costs for passengers increases this rivalry. Many airlines have tried to generate consumer loyalty by introducing frequent flyer programs, however the number of membership plans held by passengers has diminished their effectiveness. The airline industry is also characterized by slow growth and high exit costs. Although some airlines lease their planes to minimize exit costs, a number of planes are owned out right and would have to be sold at a loss.

*Threat of Entry*

A second factor affecting industry profitability is threat of entry. In the airline industry it is reasonably straightforward for a new startup airline to lease a plane and purchase contract support services for example, Reno Air and Kiwi International in the early 1990s. The introduction of a new national airline is less of a threat, however, due to limited gate space, high capital costs, reservation system costs, and the need for a recognizable “trustworthy” brand name. The potential threat of retaliatory action by existing airlines also serves as a barrier to entry.

*Substitutes*

There are several substitutes to air travel, including trains, buses, cars, and not traveling at all. Switching costs between air travel and its substitutes are not great. The importance of the various substitutes, however, will vary according to route and customer-type. Ground transportation, for example, will lose its appeal as a substitute the greater the journey-length. The propensity to make substitutes will tend to be greater among leisure travelers, who are usually more price sensitive than their business counterparts.

*Supplier Power*

Employee expenditure forms a significant part of an airline’s total costs. Employee power will vary according to the type of employee and whether or not they are unionized. Pilots, in the short term, can cause chaos for an airline through industrial action, however in the longer
term they are more easily replaceable. The power of airplanes manufacturers should be quite high, given the huge switching costs involved for airlines. Such supplier power will be less, however, for those airlines purchasing the second-hand aircraft.

*Buyer Power*

The large number of airline customers, their lack of organization and their inability to integrate upstream weakens the power of individual buyers. The extent to which airlines can charge a ticket price close to buyer value as opposed to ticket cost will vary depending on the route and type of customer. Routes where there are substitutes are more likely to have lower prices. This is especially true for coach fares whose leisure customers may choose not to travel. Business and first class fares, however, tend to be closer to customer value, and therefore help to increase airline profitability.

Porter’s five forces model helps to show that intense rivalry within the airline industry, significant supplier power, substitutes, (especially not flying), and, to some extent buyer power and the threat of entry all contribute to the industry’s lack of profitability. Why are there differences within the industry, though, that have allowed Southwest airlines to be profitable since it’s creating in 1971?

*Southwest Airlines*

There are two main factors contributing to Southwest’s success: the leadership of CEO Herb Kelleher, and the airline’s business strategy. Kelleher has created a culture at Southwest where employees feel part of an extended family. His charisma and sense of fun have helped to generate intense employee loyalty. The work force owns 11% of the company, which helps to align their interests with the airline’s overall goals. As a result, labor relations have not been a problem at Southwest even though 90% of employees are unionized. Efficient working practices and low employee turnover help to reduce Southwest’s costs, thereby making it much more competitive.
Southwest’s business strategy of “keep it cheap, keep it simple, focus your energy” has also contributed largely to its success. The airline flies out of secondary airports to gain access to cheaper gates and to avoid its competitors. Unlike its major competitors, Southwest does not operate a hub and spoke system, but rather makes frequent point-to-point flights. Its flights are short and each plane is utilized as an average of 11 hours per day (the industry average is 8), so that Southwest is able to spread its fixed costs over more seats. As a result the airline only requires a 55% load factor to break even. There are no frills such as food, seating assignments, or baggage transfers. This reduces costs and also the airplane non-productive turnaround time at gates. Southwest’s fleet consists entirely of Boeing 737s, which are more fuel efficient than the larger airplanes. Having just one type of plane also helps to reduce training costs of pilots and mechanics, and also requires lower inventory levels of spare parts.

Southwest’s business strategy helps it to differentiate itself from the other airlines. It sees itself as attracting new passengers to air travel, rather than competing with other carriers for existing travelers, (although other carriers probably do not share this view!). Employee power is relatively weak, although Boeing’s power as aircraft supplier is strong. Southwest, like all the carriers, does face the threat of entry from upstart airlines, (as discussed below). The airline sees its substitutes – buses, cars, and not traveling – as business opportunities rather than threats. Finally, Southwest, through its totally different business strategy, has successfully managed to generate customer loyalty, unlike the rest of the airlines where both product differentiation and loyalty are low.

**Threats to Southwest’ continuing success**

Southwest faces both internal threats to its continuing success – including the loss of Kelleher and/or a loss in its strategic direction – and external threats – such as new technology and new entrants to the industry. Kelleher has played a such a key role in building up Southwest, both through his business acumen and his excellent interpersonal skills, that there is a risk that, should he leave, the company would fall apart. The airline may also threaten its own
success if it changes strategic direction, (regardless of whether or not Kelleher is CEO), for example expanding into long-haul routes, (as discussed below).

One of the keys to Southwest’s success was that, as a new player in the 1970s, it purchased the new 737s which were smaller and more fuel efficient than the older, large planes of its competitors. This competitive advantage through technology could work against Southwest in the future, however. Changes in airplane technology, including the introduction of the smaller and faster regional jets (RJs)\(^2\) could give new entrants, (or existing carriers who switch their asset base), a technological advantage over Southwest. Given he high costs of switching, Southwest is currently locked in to the 30-year-old technology of the 737s.

A second external threat is one of new entrants choosing to operate on the same principles as Southwest. Although Southwest has a strong customer base and is geographically diverse, it could still be undercut on some of its routes by smaller upstarts. Similarly, the established airlines could follow the “Southwest effect”, just like the “Shuttle by United” service in 1994. Although Southwest responded to such competition with a nationwide fare promotion, it will have to be careful in the future that it is not accused of adopting predatory pricing. Despite its continued success, therefore, Southwest should not become complacent but rather constantly reevaluate its costs, prices and service.

**Should Southwest begin flying long-haul routes?**

In 1994, as a response to “Shuttle by United”, Southwest threatened to invade United’s long-haul routes. Although this was a retaliatory measure, to what extent does flying long-haul routes make sense for Southwest? Since it has had such great success in short-haul routes that it might be tempted to expand into long-haul ones. In making business decisions, though, Southwest should remember its core strategy of being a no frills, low cost airline.

Long-haul services would threaten Southwest’s current low-cost strategy in a number of ways. Passengers on long-haul flights would probably want food, thus increasing Southwest’s costs and turnaround times. Long-haul flights would raise Southwest’s fuel consumption, thus

\(^2\) S Industry and Trade Outlook 1998: Transportation, (from Business Browser)
refueling times would increase too. Average flight lengths would rise, so the number of daily flights would fall, thus reducing the number of seats over which to spread fixed costs. Southwest might also find it more economical to use larger planes for its long-haul routes, but this would conflict with its “keep it simple” strategy of only using 737s.

In terms of product differentiation, Southwest would suffer a loss of individuality, for example by serving food and having slower turnaround times. Southwest currently sees many of its potential customers as automobile-drivers and bus-users, however this customer case will diminish as journey lengths increase. As a result, rivalry between Southwest and the existing long-haul players would become more intense. There is the danger that the established carriers would retaliate against Southwest, causing damaging price-wars.

Conclusion

The airline industry is largely unprofitable, based in part on huge rivalry between the major players resulting from excess capacity, high fixed costs and low product differentiation. Southwest, however, has been successful by following a niche strategy of low costs and no frills. In order to ensure its continuing success, however, it must not become complacent. Expanding into long-haul routes is not recommended for Southwest, as it would threaten both its low costs and product differentiation, and would be likely to lead to a price war with the established long-haul carriers. If Southwest is keen to expand, it should continue to do so using its current formula. Southwest should always remember that, in order to succeed in an industry, it is often not the case of having a strategy of “doing it better”, but rather one of “doing it differently”.