

Introduction

The domestic US airline industry has been intensely competitive since it was deregulated in 1978. In a regulated environment, most of the cost increases were passed along to consumers under a fixed rate-of-return based pricing scheme. This allowed labor unions to acquire a lot of power and workers at the major incumbent carriers were overpaid.

After deregulation, the incumbent carriers felt the most pain, and the floodgates had opened for newer more nimble carriers with lower cost structures to compete head-on with the established airlines. There were several bankruptcies followed by a wave of consolidation with the fittest carriers surviving and the rest being acquired or going out of business.

Analysis of the airline industry

To determine the profitability of the airline industry, we will do an industry analysis using Porter's five-forces framework. This industry analysis will help us in understanding the size of the Potential Industry Earnings (PIE), and how much of this the different participants can extract.

Rivalry among competitors

There is intense rivalry among different airlines. In the pre-deregulation days, airlines competed mostly on things like service, meals and in-flight movies etc., since prices were mandated by the Civil Aeronautics Board. In the post-de-regulation era, this rivalry has taken on the form of severe price competition, with airlines ruthlessly undercutting each other with fare promotions.

There are a number of airlines making the airline industry fairly crowded. Even though the 3-firm concentration in 1992 was 50%, and the 8-firm concentration was 92%, the fact that the airlines competed on price made the industry much more competitive than the numbers might suggest.

The service the airlines sell (air transport) is pretty homogenous, and there is not much product (in this case, service) differentiation. The major differences between the services offered by different airlines include the total time spent on an airplane and the number of connections. While time-sensitive business travelers may prefer shorter, direct flights, most leisure travelers don't see this as a big differentiator when the price is factored in.

Buyers (both business as well as leisure travelers) have low switching costs and there is very little relationship-specific investment that travelers make. Although the airlines made an effort to create customer loyalty by offering frequent flyer programs, most of the competitive advantage this provided was quickly eroded by almost all airlines offering such programs. Moreover, leisure travelers are motivated to shop around for the best price.

The airline industry is also characterized by very high fixed costs. The majority of the operational costs (labor, landing fees, cost of aircraft etc.) are fixed regardless of how full the planes are, and the marginal cost of adding an extra passenger is almost negligible (just the cost of food plus an insignificant amount of extra fuel). Thus, on the margin, every extra seat sold contributes directly to the bottom line. This motivates airlines to undercut each other till price approaches marginal cost.

Intense competition also lead to excess seat capacity in several markets. This, combined with periods of declining demand because of macro-economic factors, and the high fixed costs and low marginal costs make the airline industry very price competitive.

Things like access to Computer Reservation Systems and innovative pricing coupled with yield management were competitive advantages for a little while before they become a staple of being in business as an airline.

Entry

Entry into the domestic airline industry is relatively easy since there are no significant barriers to entry. Inputs such as aircraft maintenance, food service, ground services, reservations etc., could be outsourced. Airplanes could be leased, thereby defraying large initial capital investments, and rights to use gates could be leased at market rates.

The minimum efficient scale was not very high since airlines could choose to compete in a few markets, and costs were more or less proportional to the number of flights offered and the number of markets the airline wanted to operate in. The main consideration for profitable entry seemed to be the ability of airlines to fill their airplanes above the break-even point. In an industry fraught with price competition, brand identity and reputation did not have significant value either.

In the airline industry, exit costs are not very high either. Planes could be easily re-deployed to other markets, or sold off, and gates and landing rights could be sub-leased to other carriers.

Substitutes

There are a number of substitutes to air travel, especially over short distances. These include taking other modes of transportation such as driving, taking the train etc., or not traveling at all. The use of technology (like WebEx, NetMeeting, video-conferencing etc.) that facilitates remote virtual collaboration is becoming a good substitute for business air travel as well.

Supplier Power

The primary inputs to the airline industry include airplanes, labor and fuel. There are only two major manufacturers (three at the time of the case – Boeing, Airbus and McDonnell Douglas) for large commercial aircraft. This, along with the relationship specific

investment that the airlines make in the form of trained mechanics, existing stock of aircraft etc., is likely to give the aircraft manufacturers some supplier power. A mitigating factor for this supplier power is the lumpy nature of aircraft sales, where there are a few high-value orders placed by airlines with deliveries spanning several years.

Labor such as pilots, cabin crew, ground personnel, gate agents etc. are typically unionized and have some bargaining power. However, many airlines especially in the post-deregulation era have used the threat of Chapter 11 bankruptcy to re-negotiate unfavorable labor contracts.

Aviation fuel is a commodity and its prices are determined largely by market forces and geo-political factors.

Buyer Power

The power that airline customers have varies based on the options available to them and the origin-destination city pair. As the General Accounting Office report in 1989 found, fares were 27% higher in monopoly or duopoly hubs than at competitive airports.

Sophisticated yield management techniques and competitive pricing have allowed airlines to extract significant consumer surplus in smaller remote markets where travelers don't have much choice and for direct long-haul flights that are preferred by business travelers.

Even though there are pockets where some airlines have pricing power, the overall airline industry is characterized by significant buyer power stemming from the intense price competition among airlines.

Industry profitability

Exhibit 1 provides a summary of this industry analysis. As highlighted by the preceding analysis, the domestic US airline industry is not very profitable. Even though the Potential Industry Earnings seem high (given the volume of air travel and the higher willingness to pay and inelasticity of demand of business travelers), airlines are not able to capture much of these potential earnings.

Several factors including intense price competition, excess capacity, high fixed and low marginal costs, along with low barriers to entry and exit, moderate supplier power and significant buyer power contribute to low industry profitability.

Southwest's success for twenty years

In spite of a rather gloomy industry outlook, Southwest Airlines has managed to be successful for over twenty years. Southwest has outperformed its competitors by pursuing an operational model that is very different from the traditional larger carriers.

Southwest was able to create a differentiated product in an industry dominated by undifferentiated offerings. Southwest took a simple, no-frills approach to flying with no meals and no assigned seating. It flew out of secondary airports where landing fees and costs of operation were much lower. These secondary airports also typically had less traffic so passengers could get to and from the airport with greater ease.

Southwest broke the hub-and-spoke model and instead opted to fly frequent flights point to point. By avoiding the hub and spoke model, Southwest did not have to make the massive infrastructure investments that a lot of its competitors had to make.

Not having to wait for feeder flights at hub airports, along with the 15-minute turn-around time of aircraft allowed Southwest to better utilize its fleet by keeping its planes in the air for a longer time (11 hours per day as opposed to the industry average of 8.5 hours per day).

Southwest also owned only one model of aircraft – the Boeing 737, and was therefore able to achieve economies of scale in stocking components, and training mechanics.

All of these measures gave Southwest the lowest cost per Available Seat Mile of 7.1 cents. As a consequence, Southwest had a much lower break-even point than its competitors and was able to make money even at lower load factors.

With this unique operational model, Southwest not only kept costs down, but also provided customers just what they were looking for – cheap, efficient, timely transportation with high-quality service from a cheerful, motivated staff and without having to wait for connecting flights at hub airports. Southwest offered the lowest prices to price sensitive airline passengers for whom cost was a significant decision criterion.

Southwest's culture

Herb Kelleher leveraged one of Southwest's key resources– its employees to create a set of organizational capabilities, which in turn gave Southwest a competitive advantage.

Kelleher institutionalized a culture of having fun while working, and inspired a deep sense of loyalty to the company from his workforce. Southwest's workforce is 90% unionized, but owns 11% of the company. This led to compatibility in incentives between Southwest and its employees.

Southwest's employees did a variety of jobs in contrast to the other major carriers where employees had designated jobs and were reluctant to do anything beyond their strictly defined duties. Having a motivated workforce helped Southwest turn an aircraft around in a record time of 15 minutes.

The beauty of Southwest's operational model was in how each of their steps reinforced the other. A simple, no-frills approach with short haul flights and standardized equipment leading to lower costs, which in turn led to lower fares in an industry which was extremely price competitive. A well-compensated, highly motivated workforce whose

incentives were aligned with those of the company also ensured that things were operating at peak efficiency.

A huge part of Southwest's success in the 20 years since its inception can be attributed to this simple, but remarkably effective model.

Threats to Southwest's continuing success

Threats to Southwest's continuing success include the threat of entry from other low-fare airlines and spin-offs from major airlines that seek to imitate Southwest's model.

With the airline industry bleeding with red ink, the government might step in and start re-regulating the industry. In general, regulation and price-setting by the government interferes with free market forces, and breeds inefficiency by creating misaligned incentives and dead-weight losses. Any such re-regulation and government mandated prices would severely hurt Southwest.

Other threats to Southwest include the loss of its existing competitive advantages. In particular, any event that triggers the loss of employee morale might lower the operational efficiency at Southwest and erode its cost advantage.

Southwest's go-forward strategy

Southwest has designed its strategy around its most important resources and capabilities. It should thus limit its scope to those activities where it has a clear competitive advantage. Southwest should try to grow by replicating its success to new markets and achieving greater economies of scale and organizational learning.

Southwest should not try to change its model and try to compete with other traditional airlines by flying long-haul flights and setting up hubs. Doing so would dilute Southwest's focus and prevent it from leveraging the competitive advantages that have served it well for over two decades.

In order to continue to succeed and grow, Southwest has to be able to sustain and build upon its existing competitive advantages. Southwest must focus on making its resources and capabilities (that give it a huge competitive advantage) durable, difficult to identify / understand, and hard to transfer and replicate.

Durability: Southwest must focus on making its capabilities more durable than its resources. The airline industry is notorious for its back-to-back boom and bust cycles, and long-lasting advantages such as brand recognition and reputation just do not exist in this industry. Thus, Southwest must constantly focus on making its existing first mover and other advantages durable by keeping its employees motivated and keeping its focus on offering simple, no-frills air travel.

Transparency: This refers to the speed with which other firms can imitate Southwest's strategy. While running an airline is not rocket-science, Southwest does seem to have cracked the code in terms of figuring out the right mix of operational procedures and

employee motivation to run a successful profitable airline. To enhance its competitive position, Southwest must focus on capturing and codifying its learning so that its formula for success is harder to identify and understand.

Transferability and Replicability: Southwest must focus on making its capabilities less transferable and replicable. Thus, even if a competitor were to acquire the same resources (airplanes, employees etc.) that Southwest has, its capabilities must be hard to transfer and replicate.

Southwest has created a unique organizational routine, and has acquired the ability to motivate its people to operate with consistently outstanding cost efficiencies and high levels of service. To build on this, Southwest must continue to focus on its core competencies, reinforce its core values and must continue to align the incentives of its employees with those of the company.

In an industry with cut-throat competition and limited profit-making potential, Southwest has successfully pursued a resource based approach to creating sustainable competitive advantages. To continue to succeed and grow, Southwest must focus on identifying and filling resource gaps and continue to offer a differentiated product by exploiting its past organizational learning and its unique characteristics.

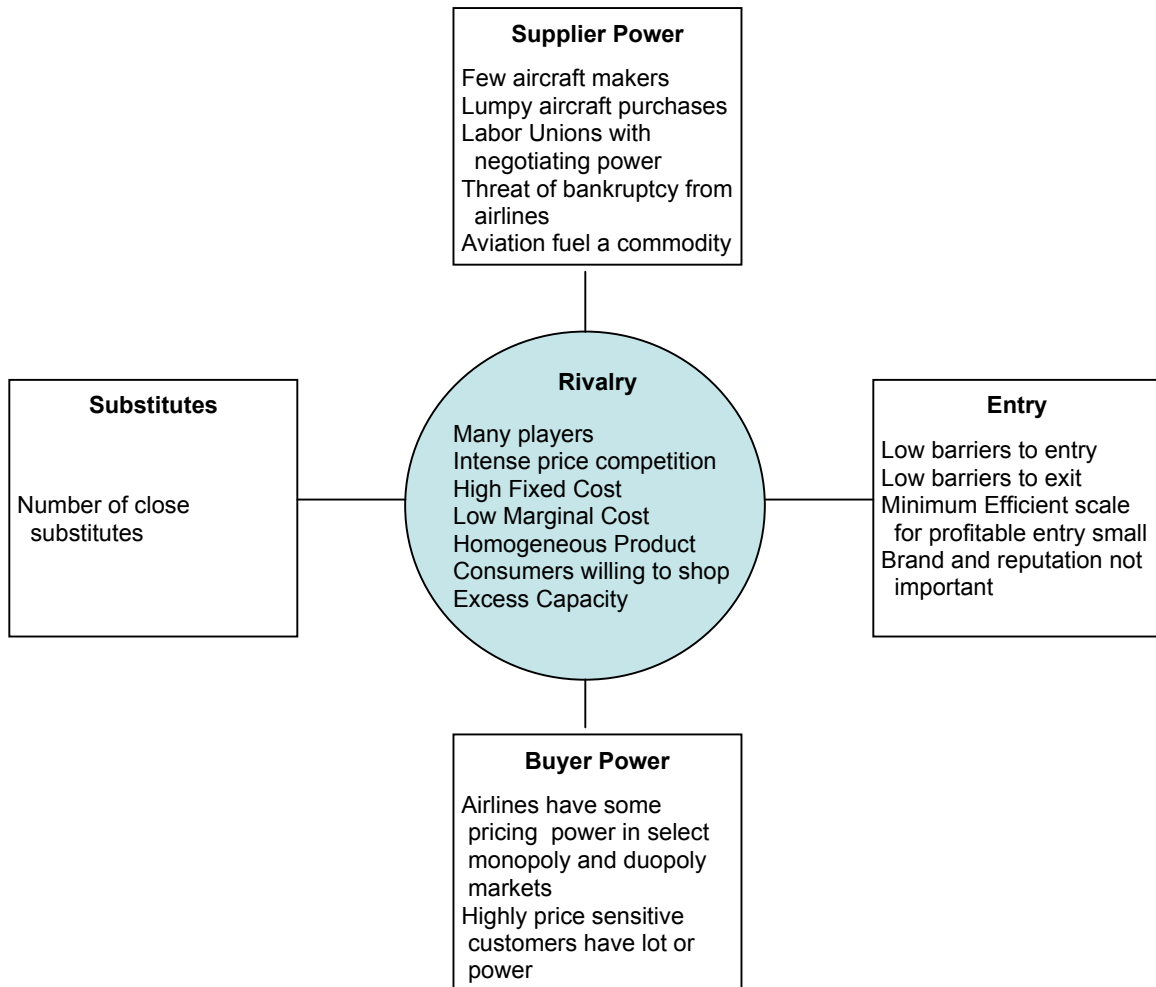


Exhibit 1: Airline Industry Analysis