

# The Southwest Effect



**SOUTHWEST  
AIRLINES**

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# Southwest's Roots

- Texan based low cost airline was established March 15, 1967 by Rollin King and Herb Kelleer
- Airline was to serve Dallas, Houston, and San Antonio
- Notion: If you get your passengers to their destinations when they want to get there, on time, at the lowest possible fare, and make darn sure they have a good time doing it, people will fly your airline
- Original Mission: make it less expensive than driving between point A and point B

# Mission Statement

## The Mission of Southwest Airlines

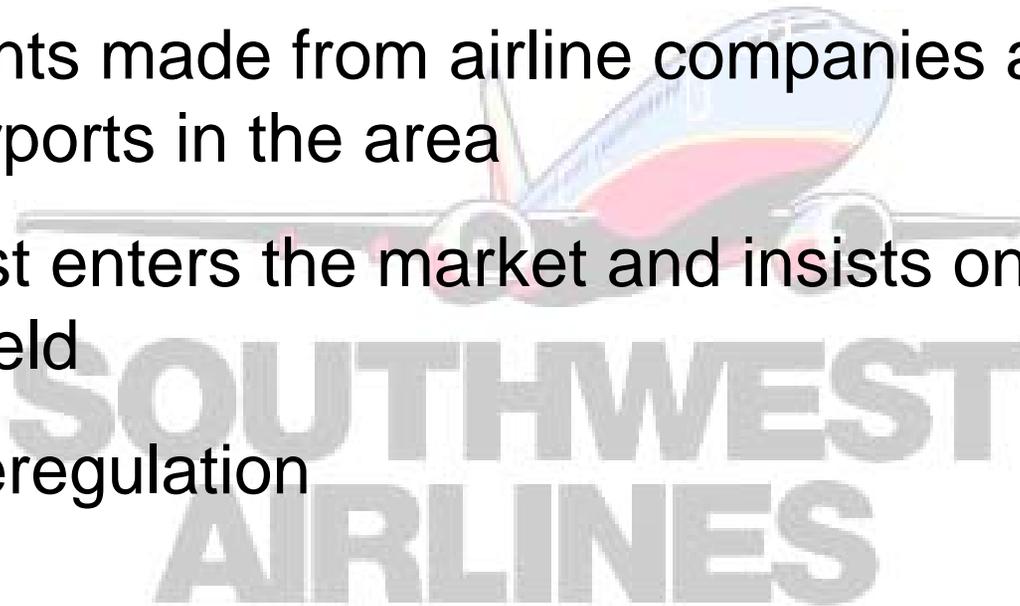
The mission of Southwest Airlines is dedication to the highest quality of Customer Service delivered with a sense of warmth, friendliness, individual pride, and Company Spirit

## To Our Employees

We are committed to provide our Employees a stable work environment with equal opportunity for learning and personal growth. Creativity and innovation are encouraged for improving the effectiveness of Southwest Airlines. Above all, Employees will be provided the same concern, respect, and caring attitude within the organization that they are expected to share externally with every Southwest Customer.

# Wright Amendment

- Need for Dallas/Fort Worth International Airport
- Agreements made from airline companies and other smaller airports in the area
- Southwest enters the market and insists on remaining at Love Field
- Airline Deregulation

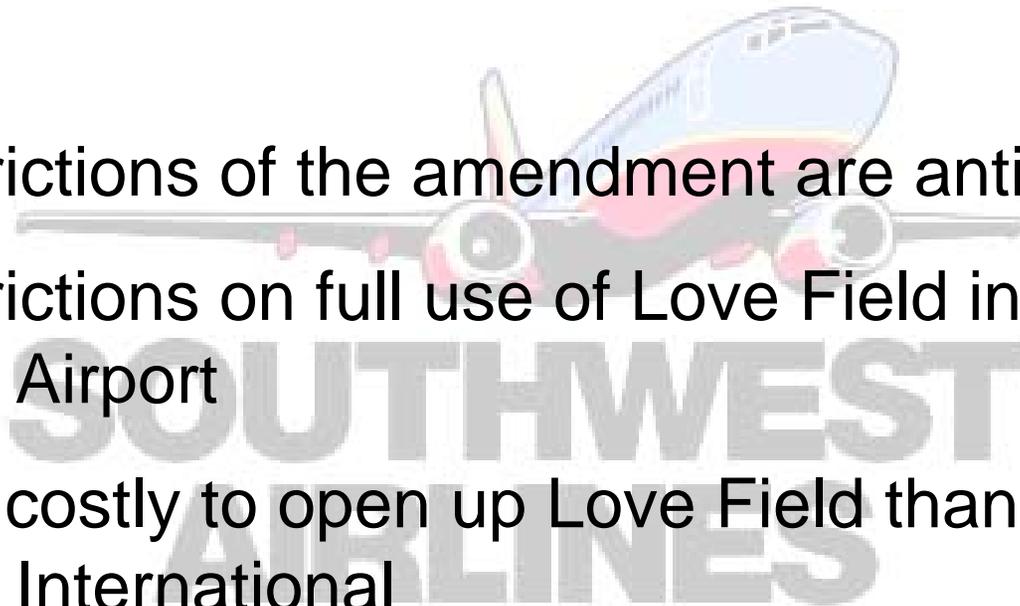


# Amendment Restrictions

- Passenger service on a regular mid-sized to large aircraft could only have operations to and from Love Field to locations within Texas and the four neighbor states of Louisiana, Arkansas, Oklahoma, and New Mexico.
- However, service outside of the four states would be allowed, only if the flight was operated by a commuter aircraft that had a capacity of 56 passengers or less.
- Airlines were not allowed to issue tickets that would violate the provisions, such as an airline booking a passenger Dallas Love to Houston then continuing on to a destination outside of the neighbor states. Also the airlines could not inform customers that they could buy multiple tickets that would allow avoiding the Amendment.

# Set Love Free!

- 1990s DFW International's air traffic exceeded capacity
- Why?
  - Restrictions of the amendment are anti-competitive
  - Restrictions on full use of Love Field inflates fares at DFW Airport
  - Less costly to open up Love Field than to expand DFW International



# Repeal Compromise

- June 15, 2006 – full repeal of the Wright Amendment with several conditions:
  - The ban on nonstop flights outside the Wright zone would stay in place until 2014
  - Through-ticketing would be allowed immediately
  - Love Field's gate capacity would be lowered from 32 to 20
  - Love Field will only handle domestic non-stop flights

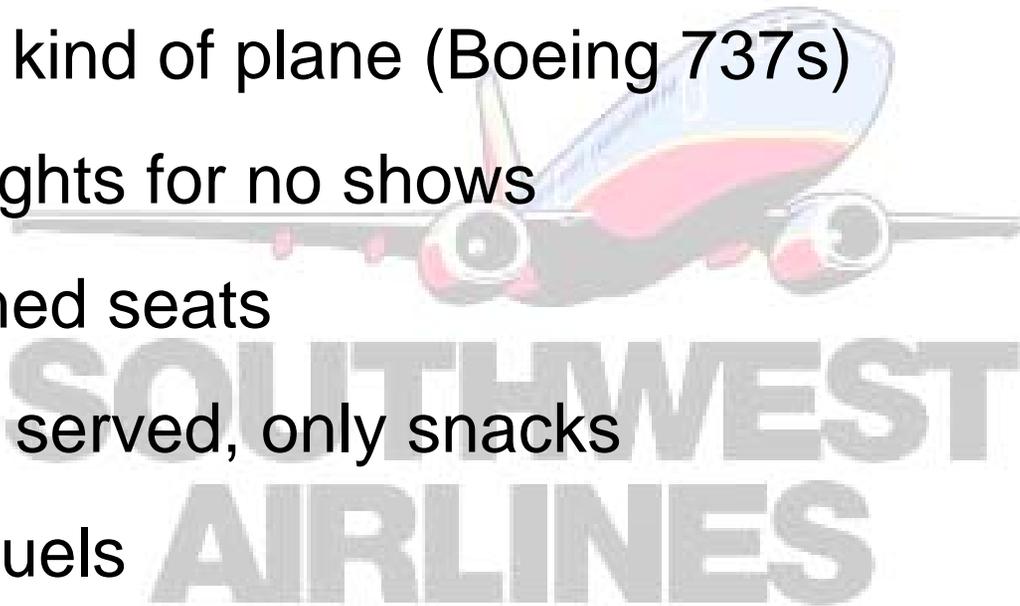
# Differentiation

- Simple transparent fares
- Change flights for free online
- Simple rewards program
- Prides itself on employee culture



# Cost Cutting Strategies

- Fly only in markets where there is high traffic
- Only fly 1 kind of plane (Boeing 737s)
- Models flights for no shows
- No assigned seats
- No meals served, only snacks
- Hedging fuels

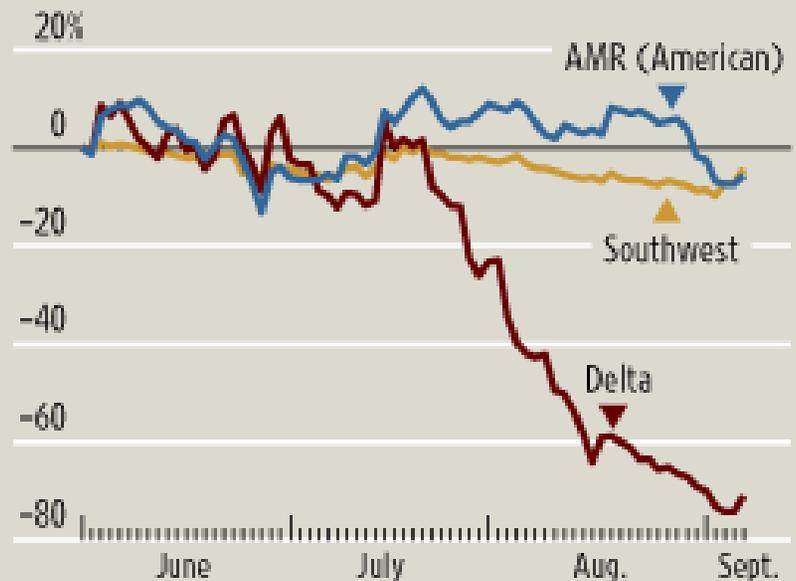


# Keeping Costs Low

- For many years, Southwest has been able to maintain low airfares for its customers
  - Southwest has used financial techniques such as fuel hedging to bolster its profitability and counteract many of the fiscal disadvantages of operating an airline.

## Oil Weighs on Carriers

Surging oil prices have hit airlines to varying degrees this summer, but the real test of their ability to stay afloat will come in the months ahead. Share performance of selected U.S. airlines:



Source: Thomson Datastream

# What is Hedging Fuel?

- Southwest has a longtime program to hedge fuel prices. It has purchased fuel options years in advance to smooth out fluctuations in fuel costs.
- Outcomes?
  - They have benefited from large gains from oil price appreciation



# Hedging Fuel At Work

According to Southwest's annual report:



| Year | % Hedged | Hedged Price/Barrel | Highest Price/Barrel in the Market |
|------|----------|---------------------|------------------------------------|
| 2007 | 95%      | \$50                | \$92                               |
| 2008 | 65%      | \$49                | \$120                              |
| 2009 | 50%      | \$51                | -                                  |
| 2010 | 25%      | \$63                | -                                  |
| 2011 | 15%      | \$64                | -                                  |
| 2012 | 15%      | \$63                | -                                  |

## Southwest's Profitable Bet

Percentage of each airline's fuel needs that are hedged against higher fuel prices and have been disclosed, with the price caps of their hedges.

|                              | 2007 4th quarter   |           | 2008 full years  |           | 2009   |           | 2010  |           |
|------------------------------|--|-----------|--|-----------|--|-----------|---|-----------|
|                              | HEDGED   | PRICE CAP | HEDGED   | PRICE CAP | HEDGED   | PRICE CAP | HEDGED  | PRICE CAP |
| Alaska <sup>1</sup>          | 50%   | \$62      | 32%   | \$64      | 5%    | \$68      | 0      |           |
| American <sup>1</sup>        | 40    | 69        | 14    | n.d.†     | 0     |           | 0      |           |
| Continental <sup>2</sup>     | 30    | 93        | 10*   | 93        | 0     |           | 0      |           |
| Delta <sup>2</sup>           | 20    | 99        | 0     |           | 0     |           | 0      |           |
| JetBlue <sup>2</sup>         | 47    | 83        | 0     |           | 0     |           | 0      |           |
| Northwest <sup>1</sup>       | 50    | 73        | 10*   | 84        | 0     |           | 0      |           |
| <b>Southwest<sup>1</sup></b> | 90  | 51        | 70  | 51        | 55  | 51        | 25%  | \$63      |
| United <sup>2</sup>          | 18  | 93        | 0   |           | 0   |           | 0    |           |
| US Airways <sup>1</sup>      | 56  | 73        | 15  | 73        | 0   |           | 0    |           |

<sup>1</sup> Price based on crude oil.

<sup>2</sup> Price based on heating oil, which is more expensive.

\* First quarter only. † Price not disclosed.

Sources: Securites and Exchange Commission filings; the companies

THE NEW YORK TIMES

# What is the Southwest Effect?

- Is a well-known phenomenon within the airline industry where markets that Southwest Airlines enter see an increase in traffic and a decrease in average airfares.
- A low-fare carrier enters a market, the market itself changes, and usually grows dramatically.
- These changes usually involve other airlines reducing their prices to remain competitive.
- Stimulates businesses in the community and also increases demand of air transportation.

# Case Studies

## Baltimore

In 1993 Southwest began providing airway services from Baltimore to Chicago Midway.

Chicago O'Hare was leader before the entrance of Southwest with 7656 passengers and average fare of \$156.35

Chicago Midway was 2nd with 552 passengers  
After Southwest was in the market for a year ,Chicago O'Hare was still the leader in terms of traffic with 13,327 and Chicago Midway with 10,790

## **Cleveland**

Southwest began serving the Cleveland–Washington, DC/Baltimore area with service to Baltimore in the third quarter of 1993.

Prior to Southwest entry, Baltimore had the highest average fare of the three area airports with an average fare of \$172.65; Washington Reagan National was next with an average fare of \$150.94 and Washington Dulles had the lowest fare at \$139.96.

Average fares in the Cleveland–Chicago O'Hare market dropped nearly by 57% to \$61.45 while average fares in the Cleveland–Chicago Midway market fell by 67% to \$39.15 after Southwest entered the market.

## **Orlando**

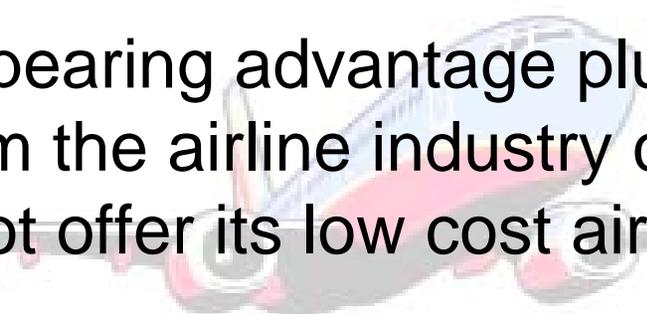
Entry of Southwest in third quarter of 1996

Prior to entry the top airport in the region from Orlando was Miami with 10,465 passengers, Fort Lauderdale was second with 4091 passengers and West Palm Beach was third with 1742 passengers.

In terms of average fares, West Palm Beach had the lowest average fare of \$82.00; Fort Lauderdale was second at \$88.00 and Miami was third \$92.69. A year after Southwest entry, the number of passengers using Fort Lauderdale increased by 125% to 9213 while the average fare dropped to \$49.00, a 44% decrease. Miami on the other hand had a less than 1% change in average fare and the number of passengers decreased by 38% to 6463.

# Can This Profitability Be Sustained?

- Below-market oil cost will not continue forever
  - Can this disappearing advantage plus tough competition from the airline industry cause Southwest to not offer its low cost airfares?



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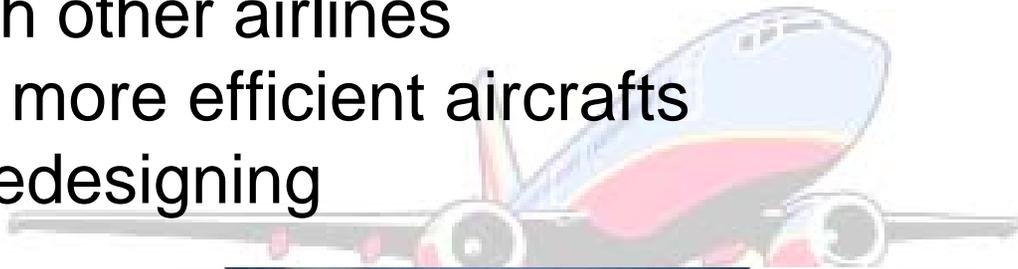
# PROBLEMS SOON TO COME...

- Set Back With the Old Technology
- Stifling Regulation (FAA)
- Open Skies Agreement
- Fuel Prices continue to Rise



# What can Airlines Do???

- Invest in new seating design
- Merge with other airlines
- Purchase more efficient aircrafts
- Think of redesigning



# How Will This Affect Consumer

- Better fares? May lower or may rise
- More travel options
- Limit flight to rural areas
- May create layoffs
- Eliminate stiff competition
- Flight experience may become unpleasant

