BUSINESS

Southwest Airlines, Once a Brassy Upstart, Is Showing Its Age

Carrier Copes With Labor Strife, High Costs; Some Pine for Days of Co-Founder Herb Kelleher

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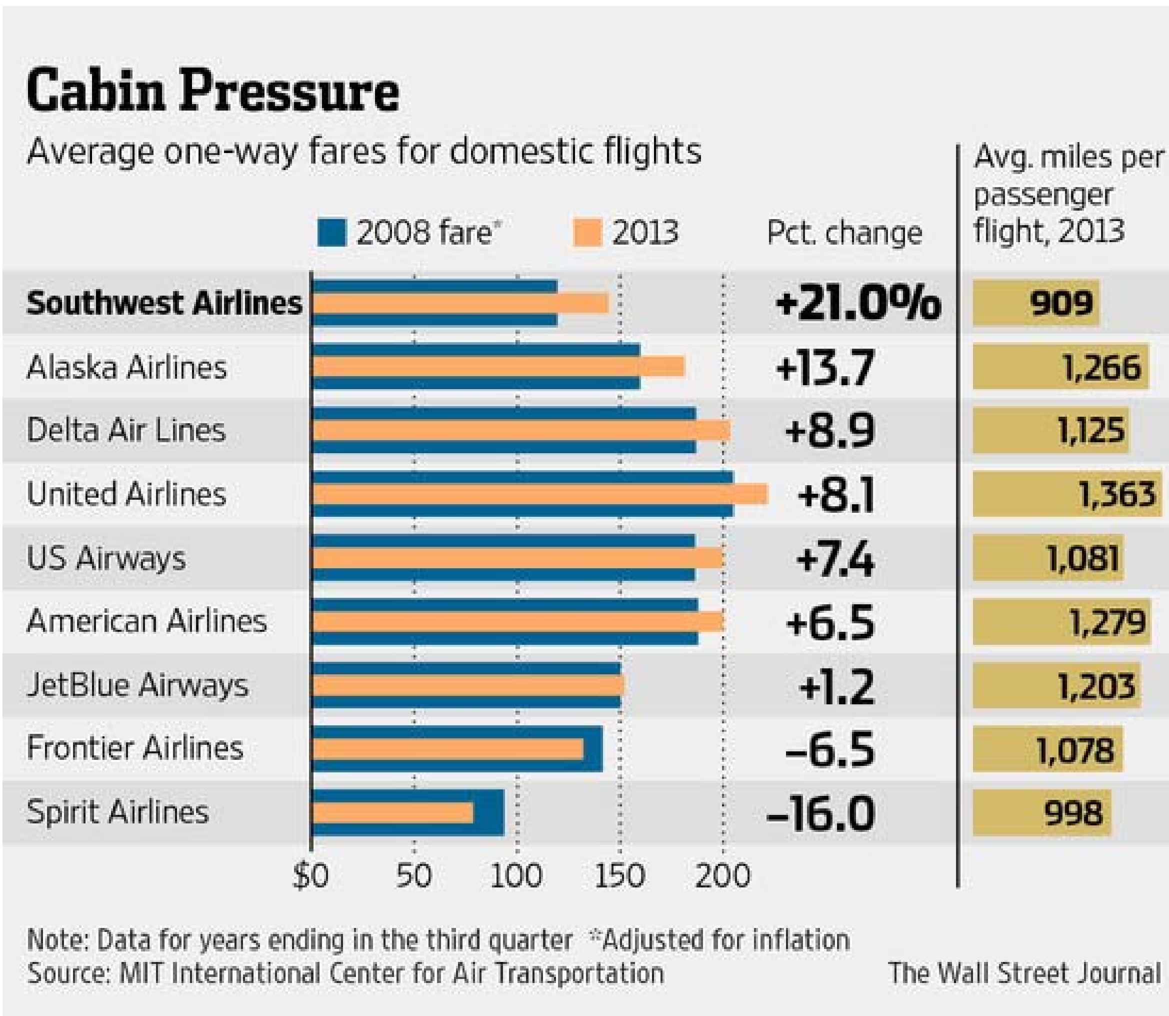


CHICAGO—At Midway Airport here on Jan. 2, Southwest Airlines Co. canceled a third of its flights, lost 7,500 bags and, at one point, had 66 aircraft on the ground—about twice as many as the carrier has gates. Passengers were stuck on the tarmac late into the night.

A severe snowstorm was the main culprit, but Southwest managers also blamed ramp workers, suggesting that nearly a third of them called in sick to protest slow contract talks. The spat boiled into a legal battle, with the workers suing Southwest for requiring they provide doctor's notes. They say they are chronically understaffed and are being blamed for executives' mismanagement of the storm.

Labor strife has long roiled the airline industry, but not Southwest. The carrier never has laid off workers or cut their pay, and has had only one strike in its history, a six-day mechanics' walkout in 1980.

Some Southwest workers, shown picketing above, miss the leadership style of co-founder Herb Kelleher. *Will Seberger for The Wall Street Journal*

But now Southwest is asking for some of the biggest contract changes ever from employees in a bid to contain costs—and some union leaders are furious. "We built this airline," says Randy Barnes, a union representative for Midway's ramp workers. Now, he says, management is "tearing it down."

The recent acrimony is one way that Southwest is showing its age. Once the industry's brassy upstart, the airline, which took wing 43 years ago, has begun to resemble the mainstream rivals it rebelled against in its youth: carriers that were slow-growing, complex and costly to run.

First sketched out on the back of a cocktail napkin in 1967, Southwest was built on simplicity, thrift, labor harmony and rapid expansion. For decades, it was the fastest-growing and lowest-cost airline in the U.S., undercutting competitors' fares in new markets and sending traffic skyward—a phenomenon known in government and industry circles as the "Southwest Effect." To help keep things simple and cost-effective, the airline flew one model of plane—Boeing Co.'s 737—and stayed close to customers with wisecracking flight attendants and funny ads. For decades, that original formula helped the company soar.

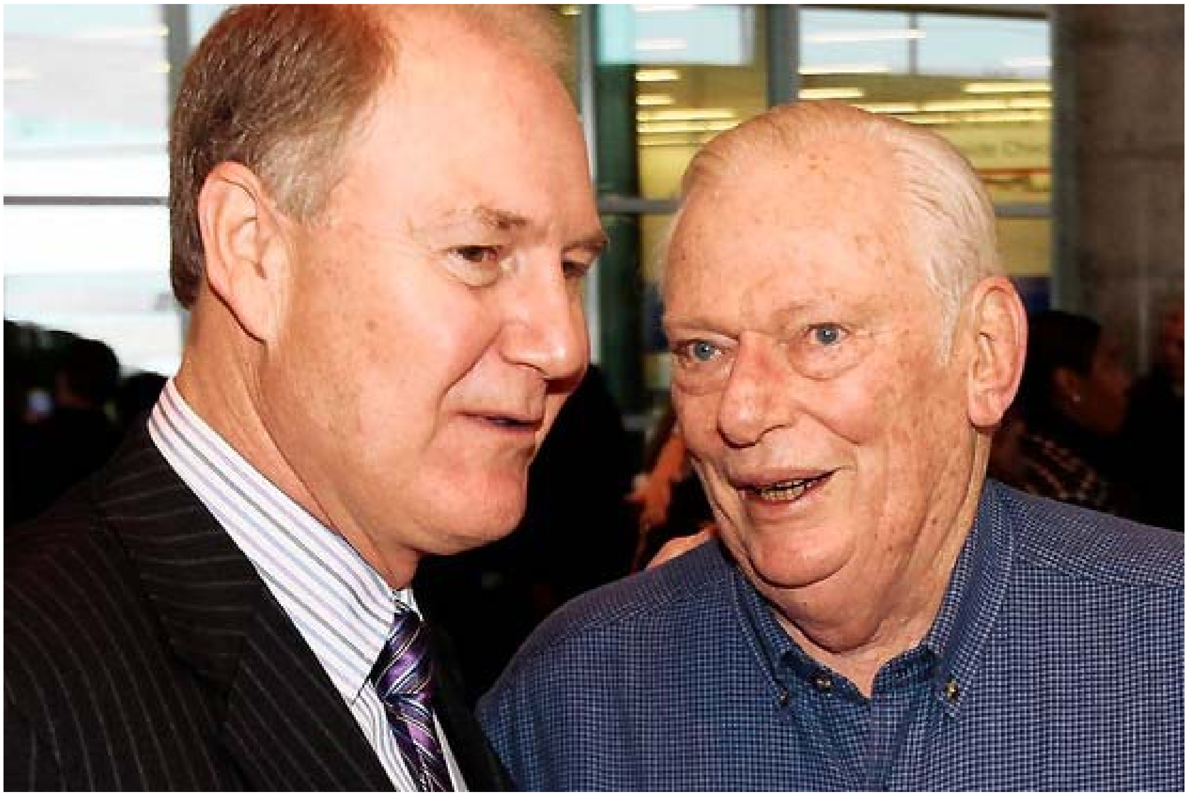
Over the past year, Southwest's stock has risen 77.6% to $23.94, and the carrier remains the only U.S. airline with an investment-grade credit rating.

Still, the airline has failed to hit its long-standing goal of a 15% return on invested capital since 2000; it recently said it doesn't intend to grow overall until it does. Even with record profit last year, its return was 13%, up from 7% in 2012.

There are other big challenges. Southwest is flying fuller planes, connecting more passengers and serving bigger airports that are prone to delays. Partly as a result, some of its operational ratings have plummeted. Last year, it lost more bags per passenger than any other carrier. And after years as one of the most punctual airlines, just 72% of Southwest's flights were on time in the fourth quarter—dead last in the industry.

Southwest was "blessed for so many years with a product nobody else had and financial results that nobody else was able to touch that they kept doing things their old way," says Bob McAdoo, an airline analyst for Imperial Capital LLC. But now, industry changes and Southwest's maturation mean "there are so many areas they're under pressure to change, things the company never had to deal with," he says.

Gary Kelly, the chief executive who has run the Dallas-based company since 2004, says the Southwest model still works. He points to record profits of $754 million for 2013—up from $421 million in 2012—and a surging stock price. He argues that the launch of international flights this year will open new avenues for growth.



Gary Kelly, Chief Executive Officer for Southwest Airlines, left, meets with Mr. Kelleher. *Bloomberg News*

"Southwest is in a better position today than it has ever been in its history," Mr. Kelly says.

But the CEO also emphasized the need for Southwest to adapt. High fuel prices, for example, have forced it to "pivot" from its longtime blueprint of offering short-haul flights between midsize cities toward longer flights between bigger cities, which use fuel more efficiently. Fuel last year accounted for 35% of Southwest's costs, more than double the share a decade ago. That shift has required it to add larger planes, drop service to many small cities and enter bigger markets while meddling with key traits like its first-come-first-served boarding process.

Other U.S. carriers, meanwhile, have bulked up and trimmed spending through mergers and bankruptcy restructurings. The three U.S. airlines larger than Southwest—American Airlines Group Inc., United Continental Holdings Inc., and Delta Air Lines Inc.—offer first- and business-class service, elite loyalty programs and global networks that capture lucrative business travelers. Ultra-discounters, including Spirit Airlines Inc., are undercutting Southwest fares while JetBlue Airways Corp. and Virgin America Inc. are competing more aggressively for the middle-class customers whom Southwest long owned.

"Not only has the world changed, but our relative position within the industry on costs has changed," says Mr. Kelly, a 59-year-old Texan and former accountant who joined the company 28 years ago. "Now we just need to make sure our labor contracts are updated to reflect the current reality."

With its growth stalled, Southwest can't hire as many new employees at the bottom of the pay scale. From 2007 through 2012, Southwest's cost to fly a seat one mile rose 42%—more than any other major U.S. airline, according to Massachusetts Institute of Technology data that adjust for flight distance.

Its low fares, long the core pitch to customers, aren't so low anymore. Its average one-way fare was $144 in the year ended in September, a 21% increase over the same period five years earlier, when adjusted for inflation. That compared with single-digit increases at larger rivals and big price cuts at new ultra-discounters like Spirit, according to the MIT data.

Many longtime customers remain loyal fans. "If there's a Southwest flight going to where I'm going, I'll fly Southwest" even if it's more expensive, says Dr. Joseph Coyle, a psychiatry professor at Harvard Medical School. "They treat everybody equally."

Mr. Kelly says Southwest's research shows that at any given time, it is the least expensive option in as few as 40% of its markets, compared with more than 50% of its markets in 2000. He notes that Southwest is almost always the best deal for fliers with checked bags, since each passenger can stash two pieces of luggage free.

While nearly all competitors impose a bag fee, Southwest has stuck by its "bags fly free" mantra—although Mr. Kelly has said he is open to charging for bags in the future.

This year holds some pivotal tests. Southwest hopes to complete its integration of AirTran Airways, which it bought for $1.5 billion in 2011, by finishing up the work of training workers, overhauling airplanes and linking the carriers' networks. It plans to begin international flights under its own brand after inheriting several Caribbean and Mexico destinations from AirTran. That will require it to master marketing in foreign countries, hire overseas workers and even make sure its flight attendants have passports.

Southwest also faces costly upgrades to its outdated computer systems—a holdover from its simpler days—to bring them in line with industry standards.

After snowstorms forced airlines to cancel thousands of flights this winter, other carriers' computers automatically rebooked many customers. But at Southwest, employees had to manually reschedule each disrupted passenger, says Teresa Laraba, Southwest's senior vice president of customers.

Another problem: Southwest's antiquated phone system limits the number of incoming calls, so some passengers were met with busy signals. Southwest says it plans to soon replace those systems. "I've been waiting a long time" for the upgrades, Ms. Laraba says.

Southwest was once a brassy upstart airline. Above, attendants in 1971. *Southwest Airlines*

Perhaps Southwest's biggest challenge involves its 45,000 workers, who long have enjoyed unparalleled job stability and compensation. About 83% of its workers are unionized, and Southwest is currently in negotiations with nearly all of them over new contracts—some of which seek to freeze pay scales.

The average Southwest worker earned nearly $100,000 in 2012, including pension and benefits, compared with about $89,000 at a traditional hub-and-spoke airline, according to MIT. Southwest also shares profits with employees, paying them $228 million last year, or more than 6% of their pay.

"It is harder today for us to claim that we are the low-fare leader than it was before because our cost advantage has been narrowed," Mr. Kelly says. "And that is exactly what we want to make our employees understand."

He says Southwest is seeking savings from increased productivity and more flexibility in workers' contracts—not from pay cuts.

For its nearly 17,000 ground workers and customer-service agents, Southwest wants to tighten rules on sick time and largely hold compensation flat. In prior contracts, workers generally received raises. It also ultimately wants 40% to be part-time, meaning their families would have to pay more for health benefits.

The company says it aims to do this by filling new openings with part-timers, rather than forcing current employees into part-time status. Still, unions blanch at the idea, saying they want to protect careers, not just jobs.

The ground-workers' union recently won a victory when the carrier backed off a proposal to outsource a sizable number of jobs to outside vendors.

Randy Babbitt, Southwest's senior vice president of labor relations, says Southwest's existing contracts were designed for a smaller, short-haul airline that didn't fly late at night or adjust service levels according to demand. For example, Southwest now flies to Fort Myers, Fla., 20 times a day in the winter and 10 times a day in the summer.

"You've got to have something flexible or part-time," Mr. Babbitt says. "It's what everybody else has. We just never needed to address it until now."

Union officials argue that Southwest employees have a more demanding workload compared with others in the industry. The airline carries about 3,000 passengers per full-time employee, compared with 1,350 passengers per employee at its bigger rivals, according to MIT's data.

The flight attendants' union says it has made clear to the company that it won't agree to a rule that would require its members to fly a minimum number of hours—standard practice in the industry.

Capt. Mark Richardson, president of the pilots union, said the slow pace of negotiations is "frustrating" but acknowledged that Southwest is distracted by talks with other work groups.

Some Southwest employees still pine for Herb Kelleher, the raucous co-founder who stepped down as executive chairman in 2008 after 30 years in the post. He was beloved by employees and known to spend hours in employee break rooms, smoking cigarettes and chatting with workers. Mr. Kelleher, 83, is famous for his love of Wild Turkey bourbon, Harley-Davidson motorcycles and outlandish costumes. He declined to be interviewed.

"Ever since Herb…left, this has been more of a corporation and less of a family," says Mr. Barnes.

The winter's brutal weather aggravated the labor rancor. Over the first week of 2014, Southwest canceled 40% of its flights at Midway and delayed another 40%, largely due to weather. The carrier said that ramp workers at Midway called in sick more than 450 times over that week, for about 22% of their scheduled shifts.

After Southwest began requiring ramp workers to provide doctor's notes, the union sued the carrier for breach of contract in U.S. district court in Dallas.

In court documents, Southwest alleged the sick calls were "widely perceived to be a coordinated job action to protest the slow progress" of contract negotiations.

The union said there was no work action, but rather a spike in illnesses fueled by mandatory overtime that exhausted workers. The union also produced work logs that it said contradicted the company's sick-call figures.

A judge dismissed the case in February and instructed the union to file a grievance, which it has.

Mr. Kelly acknowledges that "mistakes were made" during the operational meltdown but he disputes the union's claims that the company understaffed Midway or mismanaged the operation.

While he says he has no desire to replicate Mr. Kelleher's flamboyant tenure, he was recently content to call upon the former CEO to deliver one of his signature no-holds-barred insights.

On March 12, the birthday of both Messrs. Kelleher and Kelly, the two addressed employees in a video posted online. Mr. Kelly asked his predecessor, "How do you respond to employees concerned about change?"

Mr. Kelleher responded: "What I tell them is…'What we're talking about here is your future. If we don't change, you won't have one.' "

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