

CHAPTER 1. THE CONCEPT OF STRATEGY

Introduction

For my first class in a core course in strategic management, I have two major goals:

- To convey an appreciation of what strategy is—both in a business context and in other competitive arenas (sport, politics, warfare).
- To introduce the basic framework for strategy analysis – in terms of *external* analysis (the analysis of industry and competition) and *internal* analysis (primarily the analysis of resources and capabilities).

The principal themes I stress in introducing the course in strategy management are:

- The contribution of strategy to the success of organizations (and individuals, too).
- The role of strategy—especially in providing direction and integration to the activities and decisions of the firm.
- Strategy as the linkage between the firm and its external environment and the importance of *fit*—the strategy of the firm needs to fit with the requirements of the external environment (especially the needs of customers), with the resources and capabilities of the firm, with the goals of the firm, and with the structure and systems of the firm.
- The distinction between business strategy and corporate strategy.
- How to identify and describe a firm's strategy.
- How firms make strategy—which introduces the debate between the *rational design* and *process* schools of strategy.

Class Outline

Even with the first class, I find it useful to kick off with a case discussion. Given that getting students to prepare a case before the first class is fraught with difficulty. Hence, it is helpful to select a case example that students are likely to be familiar with—hence, it is possible to have a productive class discussion, even if many students have not read the case.

Hence, I use one of two cases: either my Madonna (which is one of the cases that accompanies *Contemporary Strategy Analysis*¹) or Lady Gaga (whose career is discussed in Strategy Capsule 1.2 of Chapter 1. Both of these case examples invariably provoke lively and insightful discussions. The merits of each is that they are so well-known that lack of prior reading is no barrier to discussion and their careers illustrate very effectively some key issues concerning the nature of strategy and the determinants of success.

I typically precede each discussion with a short video—either a YouTube music video or, in the case of Madonna, an extract from her *Truth or Dare/In Bed with Madonna* documentary movie.

For each of these individuals, I follow a similar approach: start by asking: “Why has Madonna/Lady Gaga been so successful?” In the case of Madonna this typically generates comments about her capacity to generate controversy, her capacity for adaptation through periodic changes in image and persona, her uses of sex as means of attracting attention and a strategic tool, and her capacity to entertain—especially within the context of multimedia extravaganza of her concerts, commitment to fame and sheer hard work.

Similar factors are evident in the much more recent career of Lady Gaga: career commitment, stunning visual imagery, a capacity to attract popular and media attention, and highly creative and theatrical video and live performances. The key differences are that Lady Gaga's images are more radical and are changed on a much speedier cycle than those of Madonna—Lady Gaga's every appearance is an opportunity for a new, usually outrageous, style. Second, Lady Gaga has fostered a different relationship with her fans than Madonna, using the faux-intimacy of social media and identification with teenage angst to build a loyal following.

Both artists have adapted their business models to the changing environment of popular music and popular entertainment. In particular, both have adapted to the decline of recorded music revenues and the rise of live performances and non-entertainment revenue streams—product placement, endorsements, licensing. In the discussion of Lady Gaga, I am often surprised at the lack of mention of her music. The conclusion I draw is that, when music is so ubiquitous and cheap, it is visual images that are the key for differentiation.

I then shift to resources and capabilities by asking the question: “Is Madonna/Lady Gaga talented?” Discussion of their capabilities as singers, musicians, songwriters, and dancers usually reveal that the key talents of both are as self-promotion, image design, communication, and marketing. Similarly, both draw upon a team of talented specialists to complement their own resources and capabilities.

This discussion typically results in a board filled with a variety of different observations. I group these into four categories:

- Clear, consistent, long-term goals
- Profound understanding of the business environment
- Appreciation of her own resource and capabilities
- Effective implementation in terms of effort, leadership, and people management.

These categories are illustrated in Figure 1.1 of Chapter 1.

I ask: “Do these different components of the success of Madonna/Lady Gaga constitute a strategy?” In neither of these individuals is there any evidence of any preconceived plan—both have pursued careers characterized by flexibility and opportunism. Yet, amidst these rich and fast-changing careers, common patterns and themes are discernible:

- Effectiveness in identifying emerging trends in music and popular culture and building them into their own music and lifestyles
- Creating integrated “product designs” that encompass music, image, personality, and lifestyle
- Reinvention/new product development—especially in the case of Madonna
- A span of activities that is multimarket, multimedia, and multinational
- Her use of strategic alliances with key individuals and organizations
- The courting of constant public and media attention.

I then go on to draw upon the issues raised in the discussion to develop some general themes concerning the nature of business strategy and the overall framework for strategy analysis:

- The nature of strategy in a turbulent environment—it's not about detailed planning; it's about consistency of decisions, clarity of direction, and focus upon the sources of success
- The framework for strategy analysis—the same elements that we derived from the Madonna/Lady Gaga discussion (in Chapter 1, Figure 1.1), form the basis of our general strategy framework that views strategy as a link between the firm and its industry environment (see Figure 1.2)
- Hence, the two primary components of our strategy analysis will be (a) analyzing the industry environment and (b) analyzing resources and capabilities.

- The development of business strategy over time. This view of strategy—as direction, as identity, and as a quest for superior performance—contrasts sharply with earlier notions of strategy as planning. Hence, I find it useful to review the evolution of strategic management thought and practice since the practice of “long-range planning” emerged in the late 1950s (see Figure 1.3).
- The process of making strategy. If strategy is not about basing detailed plans on medium-term forecasts, how should companies formulate their strategy? The debate between the “design school” and the “process school” provides an interesting way into this.

I conclude by bringing the discussion back to strategic issues facing the students in the class. Whether MBAs or undergraduates, they face critical strategic decisions with regard to future careers. I invite them to consider (a) whether they have strategies, (b) whether these strategies are implicit or explicit, and (c) how they might apply the ideas and framework outlined in the class (and in Chapter 1 of the book) to developing a career strategy. As an example of the application of strategy to managing one’s life I sometimes draw upon Stephen Covey’s *Seven Successful Habits of Highly Effective People* inviting students to participate in the exercise he outlines as the beginning of the chapter on Habit #2: Starting with the End in Mind. This exercise involves imaging one is attending one’s own funeral.

Cases to use with Chapter 1

Apart from my *Madonna* case, several cases have been used by different instructors to accompany the introductory chapter of the book. The critical factor is not so much the precise content of the case as the role of the instructor in drawing out the main issues concerning the nature of business strategy and providing a preview of the themes and issues which the course which will be dealing with. Particularly suitable cases are those which deal broadly with issues of business success; which consider the roles of goals/values, organizational resources, and the industry environment; and which can be used to embody both analytical aspects of strategy and the human and process issues (especially the role of the leader/general manager).

There is some advantage in using cases that are relatively simple – there will be ample opportunity for bewildering students with the complexity of strategic decisions as the course unfolds – and are short. (If you are beginning the first class with a case, many students will have little time for preparation.) Entrepreneurial cases also work well, including cases on Starbucks and James Dyson and the bag-less vacuum cleaner.

Starbucks Corporation, April 2012 (R. M. Grant, *Contemporary Strategy Analysis: Text and cases*, 8th edn, Wiley, 2013).

Howard Schultz’s leadership of Starbucks from a single Seattle coffee shop to a global chain of over 17,000 outlets is an inspiring tale of entrepreneurial strategy. After a downturn in performance, Schultz’s reappointment as CEO in 2008 and Starbucks’s subsequent revitalization established Schultz as one of America’s most outstanding business leaders. The case offers an opportunity to assess why Starbucks’ business strategy has been so successful and to evaluate the current strategy in relation to the changing business environment that Starbucks faces.

Other Starbucks cases suitable for an introductory discussion of strategy include:

- S. Kotha and D. Glassman, *Starbucks Corporation: Competing in a Global Market*, University of Washington, 2003, http://depts.washington.edu/bacisb/gbc/starbucks_final.doc
- *Howard Schultz and the Starbucks Coffee Company*, [Harvard Business School Case No. 9-801-361](#), 2001).

Southwest Airlines (A. C. Inkpen and V. DeGroot, “Southwest Airlines 2002” Thunderbird, 2002, http://www.tbird.edu/pdf/about_us/case_series/a07020009.pdf).

Like Starbucks, Southwest features a dynamic, founding entrepreneur – Herb Kelleher – and a consistent, clearly articulated strategy that established an unchallenged competitive advantage within the industry. The case is interesting because of success against a highly unfavorable industry background.

Doing A Dyson: Case [A] (Imperial College, ECCH Case No. 599-051-1).

James Dyson’s bag-less vacuum cleaner is a stirring tale of the trials and triumph of a determined and stubborn British inventor and entrepreneur. The case offers an opportunity to explore the role of strategy in the seemingly haphazard development of a successful startup.

Innovation and Renovation: The Nespresso Story (Kamran Kashani and Joyce Miller, [IMD Case No. 046](#), 2000; also available through HBS and ECCH).

The case traces Nestlé’s development of its Nespresso coffee system in a separate business unit using a strategy that is a radical departure from that of most of Nestlé’s businesses. The case requires students to identify and describe Nespresso’s strategy; to consider its fit, both externally with the market and internally with Nestlé’s resources, capabilities and organizational structure and systems. It also introduces ideas of strategy as innovation.

24 Hour Fitness ([Harvard Business School Case No. 706404-PDF-ENG](#), 2005)

The case considers the foundation and development of 24 Hour Fitness which, by the end of 2004, had become the world’s largest privately owned health club chain. The case allows students to identify the strategy of the firm and the reasons for its success, and to address the future strategy of 24 Hour Fitness—including expansion into the Northeast of the USA, acquisition targets, and potential threats.

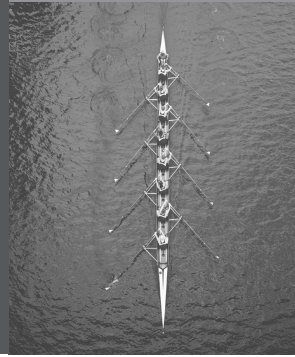
Honda [A] and [B] (Harvard Business School Case Nos. [9-384-049](#) and [9-384-050](#)).

Chapter 1 of *Contemporary Strategy Analysis* discusses the debate between the “rational design” and “process” schools of strategy and refers to the Honda case as a central feature of this debate. This account by Richard Pascale of Honda’s entry into the US motorcycle market at the beginning the 1960s is one of the most insightful strategy cases ever written. The strength of the case is its two stories of the same events. The “A” case reviews Honda’s success in motorcycles through the eyes of the Boston Consulting Group—a tale of careful analysis and rational decision making. The “B” case tells the story of Honda’s US entry in the words of the managers involved—a tale of guesswork, errors, and luck.

Although the case is somewhat complex as an introduction, it provides a uniquely insightful contrast between rational and process views of strategy.

¹ “Madonna: Sustaining Success in a Fast Moving Business” (in R. M. Grant, *Contemporary Strategy Analysis: Text and Cases*, 8th edition, John Wiley & Sons, 2013; also available through www.contemporarystrategyanalysis.com).

AES Corporation: Rewriting the Rules of Management



God made us all a certain way. We're all creative, capable of making decisions, trustworthy, able to learn, and perhaps most important, fallible. We all want to be part of a community and to use our skills to make a difference in the world.

DENNIS BAKKE, CEO, AES

We broke all the rules. No overtime. No bosses. No time records. No shift schedules. No assigned responsibilities. No administration. And guess what? It worked!

OSCAR PRIETO, AES MANAGER AND DIRECTOR OF LIGHT
SERVICIOS DE ELECTRICIDADE, BRAZIL, OCTOBER 1998

Spring 2002 presented AES Corporation, the world's largest independent power generator, with the most difficult business circumstances in its 21-year history. After a decade of strong growth and a steeply rising market valuation that had taken AES into the S&P 500 in 1998, AES's world had been shaken to its foundations by four major shocks. The first was the Californian power crisis of 2001. Despite limited involvement in the Californian electricity market, AES was immersed in the recriminations, lawsuits, and regulatory investigations that had followed California's electricity debacle. Second, AES had been caught up in the wake of Enron's collapse at the end of December 2001. Although AES's direct losses resulting from Enron's bankruptcy amounted to a mere \$15 million, Enron's collapse had a profound impact on investors' risk perception and upon the legitimacy of a range of previously accepted business practices, including off-balance-sheet financing. The third crisis having an impact on AES was Argentina. Argentina represented one of AES's largest overseas interests, with over \$1 billion

invested. The meltdown of the Argentine economy had rendered these investments all but worthless and had had knock-on effects on AES's power interests in Brazil. The gloom affecting AES's Latin American operations was further increased by the mounting crisis in Venezuela. Finally, the aftermath of the September 11, 2001 terrorist attacks on the US had created further uncertainties for AES's global interests. With investments in several Muslim countries – in particular Pakistan and Kazakhstan – AES was again subject to greatly increased financial, political, and physical risk.

These factors had combined to ensure AES's entry into the infamous "90% club" – those companies (mainly technology, media, and telecommunication companies) that had lost more than 90% of their stock market value. After touching \$70 a share in September 2000, AES's share price had fallen below \$4 in February 2002. The sharp decline in AES's market value had placed considerable strain on AES's finances, making it increasingly difficult for AES to access the capital markets. In February, ratings on AES's unsecured debt were cut to below investment grade.

These combined pressures had forced an abrupt reversal of strategy at AES. After two decades of continuous and rapid expansion, the company was forced to retrench. In a series of measures announced in February 2002, AES began the desperate task of shoring up its finances and protecting itself against an increasingly hostile external environment.

For co-founder and CEO Dennis Bakke the most troubling aspect of the sudden strategic shift was not the abandonment of AES's ambitious growth targets. He believed that AES possessed the financial and management strengths needed to survive the current financial pressures. His concerns related much more to his personal mission to build AES as a different kind of company. Under the leadership of its two co-founders, Roger Sant and Dennis Bakke, AES had rejected profit and shareholder wealth as its *raison d'être* and committed itself to the pursuit of integrity, fairness, fun, and social responsibility. These principles were embedded in a management system that was referred to by board member Robert Waterman (of *In Search of Excellence* fame) as an "adhocracy," and which the *Wall Street Journal* described as "empowerment gone mad."¹ There were no staff functions or corporate departments; almost all traditional management functions were devolved to workers at the plant level.

So long as AES was a darling of Wall Street, investors and analysts were happy to accept AES's lofty values and its founders' disdain for profit. But the events of 2001 and early 2002 had changed all that. AES's values and unique management system – which had been so effective in encouraging employees' loyalty and commitment, generating initiative and entrepreneurial drive, and promoting unmatched levels of operational efficiency – now had to come to terms with a very different environment.

AES had grown from an entrepreneurial startup to a public corporation with 38,000 employees and 179 plants in 31 countries. Could a management system based on trust, fun, openness, and decentralized decision making work in a large complex organization that embraced national cultures ranging from traditional Islamic societies (Pakistan), to post-communist systems (Hungary, Bulgaria, Ukraine, Kazakhstan) and the oligarchic societies of Latin America? AES's industry environment was also changing. During the 1990s, AES was one of a small number of independent power producers that was riding a wave of opportunity as governments throughout the world privatized their state-owned electricity sectors. During the 21st century the flow of privatization opportunities was slowing while competition was growing. New entrants into electricity production included not just the independent power producers but

also traditional utilities (Duke Power, Consolidated Edison, Electricité de France), gas companies (Centrica, Gaz de France), and oil majors (BP, Shell, Exxon Mobil).

AES's Origins and Development

In January 1982, Roger Sant and Dennis Bakke founded Applied Energy Systems based in Arlington, Virginia. Their purpose was to take advantage of a 1978 Public Utility Regulatory Policy Act (PURPA) that required utilities to purchase power from independent energy producers. Sant and Bakke believed they could build a business in a niche segment of the enormous power-generation industry.

At first glance, Sant and Bakke seemed a rather unlikely pair to start what was to become a large international energy company. Although both held Harvard MBAs, their experience was primarily public sector. Sant headed the Ford Administration's energy conservation efforts and Bakke served as a chief aide. Following government service, they moved on to the Mellon Institute's Energy Productivity Center, where they researched energy conservation. It was during this time that the pair came up with the idea of starting their own company.

Sant and Bakke had a very difficult time raising money at first, because nobody took them very seriously. According to Bakke, "[we] had the worst possible background for raising money . . . first government and then academic experience. It looked to investors like a combination of inefficiency and ivory tower."² However, Sant and Bakke had one key advantage: as a result of their involvement in drafting PURPA, they were among the first to recognize the opportunity for independent generators to produce power at much lower costs than the established utilities.

After several joint ventures (notably with Arco) Sant and Bakke decided to go it alone and in 1985 built their first power plant adjacent to an oil refinery in Houston, Texas. The plant was not profitable; however, the second and third plants that AES built "weren't disastrous, and four, five, and six turned out to be superb. By 1989 it was clear that we had reached viability."³

In 1991, AES went public. With a stronger equity base it was ready to look at opportunities overseas. Because of the rapid growth in electricity demand in many emerging markets, inadequate generating capacity, and the trend towards privatization, Sant estimated that over 70% of AES's opportunities lay outside the US. The fast-growing Asian markets for electricity, especially the huge potential markets of India and China, were especially attractive. In the early 1990s, AES acquired two plants in Northern Ireland and one in Argentina. International expansion involved participating in the auctioning of state-owned power plants by governments, and bidding for long-term contracts to supply power to electricity utilities. During the mid-1990s, AES's biggest new investments in power generation were in Kazakhstan and China. The 1996 acquisition of Light Serviços de Electricidade, Brazil, was a major strategic departure for AES: this was its first entry into the distribution end of the power business. Deregulation was also creating opportunities in the US. Changes in utility regulations at the state level resulted in some utilities selling off their generating facilities – AES was among the most prominent bidders for these facilities.

Between 1998 and 2001, AES continued to expand rapidly both at home and overseas. Tables 19.1 and 19.2 show AES's plants and distribution facilities at the end of 2001.

TABLE 19.1 AES's generating plants, December 31, 2001

Country	Number of plants	Generating capacity (MW)	Date of entry	Notes
USA	30	38,729	1986	15 coal, 14 gas, 1 oil
Canada	1	110	1997	1 gas
Brazil	10	9,711	1996	8 hydro, 2 gas
Argentina	6	3,353	1993	2 gas, 3 hydro, 1 coal
Chile	4 (?)	1,716	2000	1 gas, 1 hydro, 1 coal
Venezuela	4	2,265	2000	4 gas
Colombia	2	1,090	2000	1 hydro, 1 gas
Panama	3	380	1999	3 hydro
Mexico	1	484	2000	1 gas
Puerto Rico	1	454	2002*	1 coal
Dominican Republic	3	1,107	1996	2 gas, 1 oil
UK	7	5,763	1992	3 gas, 4 coal
Netherlands	1	415	1998	1 gas
Italy	1	140	2001	1 oil
Hungary	3	1,331	1996	1 gas, 2 coal
Georgia	3	823	2000	2 hydro, 1 gas
Kazakhstan	8	8,414	1996	6 coal, 2 hydro
Pakistan	2	695	1997	2 oil
India	1	420	1998	1 coal
Bangladesh	2	810	2001	2 gas
Sri Lanka	1	165	2002*	1 gas
Oman	1	427	2003*	1 gas
Qatar	1	750	2004*	1 gas
China	4	1,665	1997	3 coal, 1 oil
Australia	3	1,247	1999	2 gas, 1 oil
Nigeria	1	290	2001	1 gas
Cameroon	1	800	2001	1 hydro
Tanzania	1	112	2003*	1 gas
South Africa	1	600	2001	1 coal

*AES to commence production.

SOURCE: AES 10-K REPORT FOR 2001.

The result of the years of expansion was not only a substantial growth in the size of AES between 1998 and 2001, but also increasing complexity of the business as AES diversified its activities within the power sector. During 2001, AES recognized four lines of business activity:

- *Contract generation* – producing electricity supplied on long-term contracts (5 to 30 years) to distribution companies.
- *Competitive supply* – generating facilities that sell electricity directly to wholesale and retail customers in competitive markets. Output is sold into power pools, into daily spot markets, and on short-term contracts.

TABLE 19.2 AES's electricity distribution businesses, December 31, 2001

Country	Gigawatt hours	Customers served (000s)	Date of entry
USA	22,999	626	1999
Brazil	86,949	12,137	1996
Argentina	4,822	698	1997
Venezuela	9,724	1,132	2000
El Salvador	669	226	2000
Dominican Republic	2,990	350	1999
Georgia	2,200	370	1998
Kazakhstan	2,572	469	1999
Ukraine	5,540	1,146	2001
India	2,102	600	1999
Cameroon	3,020	452	2001

SOURCE: AES 10-K REPORT FOR 2001.

TABLE 19.3 Revenues and gross profit by line of business, 2000 and 2001

	Revenue (\$ billion)		Gross profit (\$ billion)	
	2000	2001	2000	2001
Contract generation	1.7	2.5	0.77	0.83
Competitive supply	2.4	2.7	0.56	0.44
Large utilities	2.1	2.4	0.54	0.74
Growth distribution	1.3	1.7	0.13	0.30

SOURCE: AES 10-K REPORT FOR 2001.

- *Large utilities* – regulated monopolies supplying electricity within specific geographical areas. These utilities combine generation, transmission, and distribution capabilities.
- *Growth distribution* – distribution facilities that offer significant potential for growth because they are located in developing countries or regions where the demand for electricity is expected to grow at a higher rate than in more developed areas.

Table 19.3 shows revenues and gross profit earned by AES's four lines of business.

Performance

AES's financial and operating performance during the 1990s placed the company among the top-performing firms of the decade, not only in its sector, but across the stock market as a whole. During 1991–2000, AES's return on equity averaged 25%, while in the five years up to the end of 2000, returns to shareholders averaged 70% a year.

This performance amazed many observers, given the limited priority that AES accorded profits and shareholder return. In monitoring its own performance, AES emphasized four performance measures:

- *Shared values* – How did we do in having an organization that is fun, that is fair, that acts with integrity, and that is socially responsible?
- *Plant operations* – How safe, clean, reliable, and cost-effective were our facilities?
- *Assets* – What changes occurred in our assets, including AES people, during the year? This intends to measure the company's project development and construction progress as an indicator of future earnings potential.
- *Sales backlog* – What happened to our backlog of contract revenues during the year?

AES's performance targets combined operational efficiency, employee satisfaction, community development, project development, and growth. For example, AES's goals for 1998 were stated in "Our Wish List" published in the 1997 Annual Report. These included:

- Continuing progress in adapting to and living the AES principles and values.
- Creating the most fun workplace since the beginning of the industrial revolution, and eliminating hourly payment systems.
- Adding 10 to 15 new businesses to the AES portfolio.
- Engineering a breakthrough in slow development businesses such as Ib Valley (India), Puerto Rico, and Nile Power (Uganda).
- Maintaining 100 new business ideas in the development pipeline.
- Making our 1998 budgeted net income and cash flow.

Operationally, AES plants were among the best performers in their industry. AES's US plants typically operated at around 95% capacity, compared with an industry average of 83%. Nor was operational excellence restricted to new plants. AES's West Belfast power station has achieved 95% availability in some years, remarkable for a 43-year-old facility.

During 2001, AES's financial performance deteriorated sharply. Although revenues grew by a healthy 24%, this was mostly from acquiring new businesses and adding new plants. Revenue from existing operations grew by a more modest 5%. Net income fell by two-thirds as a result of lower market prices in the UK, decline in the Brazilian Real resulting in currency losses of \$210 million, losses from closed telecom activities of \$194 million, and higher expenses.

Table 19.4 summarizes some key indicators of AES's performance during 1991–2001.

Values and Principles

AES's unique organization and management systems were the direct result of the values upon which the company was established and which defined every aspect of its management. These values reflected the personal beliefs of the two founders, Roger Sant and Dennis Bakke. Both men were brought up in strongly religious families:

TABLE 19.4 AES's performance, 1991–2001

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Revenue (\$ million)	334	401	519	533	679	835	2,227	3,257	4,117	7,534	9,327
Sales backlog (\$ billion)	n.a.	29	27	43	41	51	98	116	138	217	n.a.
Net income (\$ million)	43	56	71	98	107	125	299	441	357	795	273
Earnings per share (\$)	0.16	0.20	0.25	0.33	0.35	0.40	0.79	1.11	0.84	1.66	0.52
Total assets (\$ billion)	1.4	1.6	1.7	1.9	2.3	3.6	11.1	12.9	23.2	33.0	36.7
Long-term debt:											
Non-recourse (\$ billion)	n.a.	1.1	1.1	1.0	1.1	1.6	4.5	4.5	9.5	12.7	14.7
Recourse (\$ billion)	n.a.	0.1	0.1	0.1	0.1	0.5	1.1	1.6	2.2	3.5	4.9
Stockholders' equity (\$ billion)	n.a.	0.2	0.3	0.4	0.6	0.7	2.0	2.4	3.3	5.5	5.5
Equity generating capacity (thousands of MW)	0.7	1.2	1.5	1.5	2.1	3.4	4.6	n.a.	n.a.	n.a.	50.8
Return on average equity (%)	48.6	35.1	29.2	28.3	22.6	19.7	17.1	20.2	12.6	17.9	4.9

SOURCES: ANNUAL REPORTS, UBS SECURITIES EQUITY RESEARCH.

Bakke as a Baptist, Sant a Mormon. Bakke was raised on a farm in Washington State. From the age of five he had worked in the fields and by the time he was 18 he had built up a herd of 29 beef cattle. Bakke's attitude to enterprise and material possessions was strongly influenced by ideas of Christian stewardship, which emphasized responsibility, building for the future, and sharing good fortune with others. Sant attended Brigham Young University and spent two years as a missionary with Native Americans in Wisconsin. Over time, Sant became less committed to the church and increasingly active in the environmental movement.

From the outset, both men viewed AES as an opportunity for them to pursue their values and effect a fundamental change in business practices. In a section of its 10K report entitled "Principles, Values and Practices," AES stated:

A core part of AES's corporate culture is a commitment to "shared principles or values." These principles describe how AES people endeavor to commit themselves to the Company's mission of serving the world by providing safe, clean, reliable and low-cost electricity. The principles are:

- Integrity – AES strives to act with integrity, or "wholeness." AES people seek to keep the same moral code at work as at home.
- Fairness – AES wants to treat fairly its people, its customers, its suppliers, its stockholders, governments, and the communities in which it operates.

- Fun – *AES desires that people employed by the Company and those people with whom the Company interacts have fun in their work. The Company believes that making decisions and being accountable is fun and has structured its organization to maximize the opportunity for fun for as many people as possible.*
- Social Responsibility – *Primarily, the Company believes that doing a good job at fulfilling its mission is socially responsible. But the Company also believes that it has a responsibility to be involved in projects that provide other social benefits, and consequently has instituted programs such as corporate matching of individual charitable gifts in addition to various local programs conducted by AES businesses.*

AES recognizes that most companies have standards and ethics by which they operate and that business decisions are based, at least in part, on such principles. The Company believes that an explicit commitment to a particular set of standards is a useful way to encourage ownership of those values among its people. While the people at AES acknowledge that they won't always live up to these standards, they believe that being held accountable to these shared values will help them behave more consistently with such principles.

AES makes an effort to support these principles in ways that acknowledge a strong corporate commitment and encourage people to act accordingly. For example, AES conducts annual surveys, both company-wide and at each business location, designed to measure how well its people are doing in supporting these principles through interactions within the Company and with people outside the Company. These surveys are perhaps most useful in revealing failures, and helping to deal with those failures. AES's principles are relevant because they help explain how AES people approach the Company's business. The Company seeks to adhere to these principles, not as a means to achieve economic success but because adherence is a worthwhile goal in and of itself.⁴

Sant and Bakke recognized that these values could not be easily reconciled with the concept of a shareholder-focused, profit-maximizing corporation, and both leaders made it very clear where their priorities lay:

Where do profits fit? Profits . . . are not any corporation's main goal. Profits are to a corporation much like breathing is to life. Breathing is not the goal, but without breath, life ends. Similarly, without turning a profit, a corporation too, will cease to exist . . . At AES we strive not to make profits the ultimate driver of the corporation. My desire is that the principles to which we strive would take preeminence.⁵

AES's commitment to its values, at the expense of shareholder gain where necessary, was indicated by the proviso that AES inserted in all of its prospectuses for new security offers which identified AES's values as a source of investor risk:

The Company seeks to adhere to these principles, not as a means to achieve economic success, but because adherence is a worthwhile goal in and of itself. However, if the Company perceives a conflict between these principles and profits, the Company will try to adhere to its principles – even though doing so might result in dominated or forgone opportunities or financial benefits.⁶

The AES principles and their implementation reflected a set of assumptions about human nature. Sant and Bakke believed in the ultimate goodness of people – “Man is made in the image of God,” declared Bakke.⁷ Hence, within organizations, people can and should be trusted to exercise responsibility, and at the same time should be held accountable. Critical to the ability to motivate people is the innate desire of people to make a contribution to society. This implies that, for an organization to be effective and to harness human effort and ingenuity, the organization must be committed to a wider social purpose. These views are at variance with many of the assumptions on which many traditional management systems and techniques are based and imply a different approach: “[t]he people in AES are not principally economic resources. We are not tools of the corporation. Rather we hope the corporation is structured to help individuals make a difference in the world that they could not otherwise make.”⁸ Table 19.5 summarizes some of the ways in which Bakke believed that AES was different from other companies.

Organizational Structure and Management Systems

AES’s organizational structure and management systems were manifestations of its values and principles. AES described the key features of its organization in its statement of values:

In order to create a fun working environment for its people and implement its strategy of operational excellence, AES has adopted decentralized organizational principles and practices. For example, AES works to minimize the number of supervisory layers in its organization. Most of the Company’s plants operate without shift supervisors.

The project subsidiaries are responsible for all major facility-specific business functions, including financing and capital expenditures. Criteria for hiring new AES people include a person’s willingness to accept responsibility and AES’s principles as well as a person’s experience and expertise. Every AES person has been encouraged to participate in strategic planning and new plant design for the Company. The Company has generally organized itself into multi-skilled teams to develop projects, rather than forming “staff” groups (such as a human resources department or an engineering staff) to carry out specialized functions.

Many people have asked us about our team structure and how it works. To begin with, there is no one person in charge of teams and there is no Human Resources department. Teams are the basis of our structure, and they encompass the four values of our company. They are fluid; many people are members of more than one team at one time. A team is somewhat autonomous; all decisions about a project are made within that team, with final say granted to that team. Decisions are made not from the top-down, but from the bottom-up. Furthermore, responsibility is pushed to the lowest level possible, encouraging everyone to be part of a decision. As a result, each team member views the project in terms of a whole. Colleagues and team members must trust each other to follow through to the best of their ability.

Because people are what make up AES, we have decided not to resort to an organizational model. Instead, we give you the following comments from AES people regarding teamwork. In general, AES teams work extremely well in both

TABLE 19.5 What made AES different?

Conventional approach	Dennis Bakke's approach
More than 95% of important decisions are made by official leaders of the organization, officers and board members	Some 99% of all important decisions are made by non-leaders
Employees have established expenditure limits above which they must obtain prior approval	No approval by supervisors and higher-ups is required for spending company money; only obtaining advice is mandatory
Organization charts are published and job descriptions are determined for everyone by managers and HR dept.	No official organization charts; no job descriptions except those that say "Do whatever it takes" or ones written by the employee
Under "control" philosophy, the job of supervisors is to make decisions, hold people responsible, and perform a host of other tasks, making it impossible for more than a few people to report to any one leader. A large organization may require eight to 12 layers of management	No more than three to five supervisory layers between the CEO and an entry-level person. Each person is responsible for managing himself or herself
Leaders see their role as managing people and resources	Leaders see their role as serving other employees
Managers are responsible for closely monitoring employees and holding them accountable for performance	Leaders advocate self-accountability, self-initiative, self-control, and individual responsibility among employees
Many separate staff groups oversee operations. Members of each staff group have similar skills and educational backgrounds	Minimal number of specialist staff groups (strategy, finance, HR, etc.). These functions are assigned to local operating teams
Financial management, risk assessment, and new business development are set apart from general operations	Financial management, risk assessment, and new business development are important elements of each person's job
The principal purpose of the company is creating shareholder value, although other purposes or goals may be mentioned	The principal goal or purpose of the company is stewarding its resources to serve society in an economically strong manner
Shared values are promoted as a technique to achieve economic goals	Shared values are goals to which the company aspires in and of themselves
Board of directors sees primary role as representing the interests of shareholders	Board of directors sees role as representing the interests of all stakeholders (employees, suppliers, shareholders, customers)

achieving a common goal and having fun while doing so. The following ideas provide insight on what makes teams work well and what can stimulate true and productive teamwork.

"Teams imply friendship; not only the ability but the desire to work together. Starting with the wonderful example set by the original AES team, Roger and

SOURCE: DENNIS W. BAKKE, JOY AT WORK: A REVOLUTIONARY APPROACH TO FUN ON THE JOB (SEATTLE, WA: PVG, 2005), EXTRACTS FROM APPENDIX B, PP. 295-303.

Dennis, working together in small groups has been a natural way to get big things done while preserving the dignity of each person.” Tom Tribone.

“There are two reasons why teams are successful at AES: the type of people we have here and the environment in which they work. People at AES tend to be independent and thrive in a loose environment where roles and responsibilities are not always clearly defined. The environment at AES is one where responsibility is pushed down to the lowest level possible, encouraging everyone to take ownership for not only their piece of the project, but for the project in its entirety.” Michael Cranna.⁹

This is not to say that AES lacked formal structure altogether. The most striking feature of its organization was the few layers of hierarchy: until the mid-1990s there were only three organizational layers between the front-line employees and the CEO. AES was divided into regional organizations or “groups.” These groups comprised the different plants, each of which was headed by a plant manager. Within each plant there were typically seven areas or “families,” each of which was headed by a superintendent.

Figure 19.1 shows AES’s formal structure at the beginning of 2002.

No Functional Departments

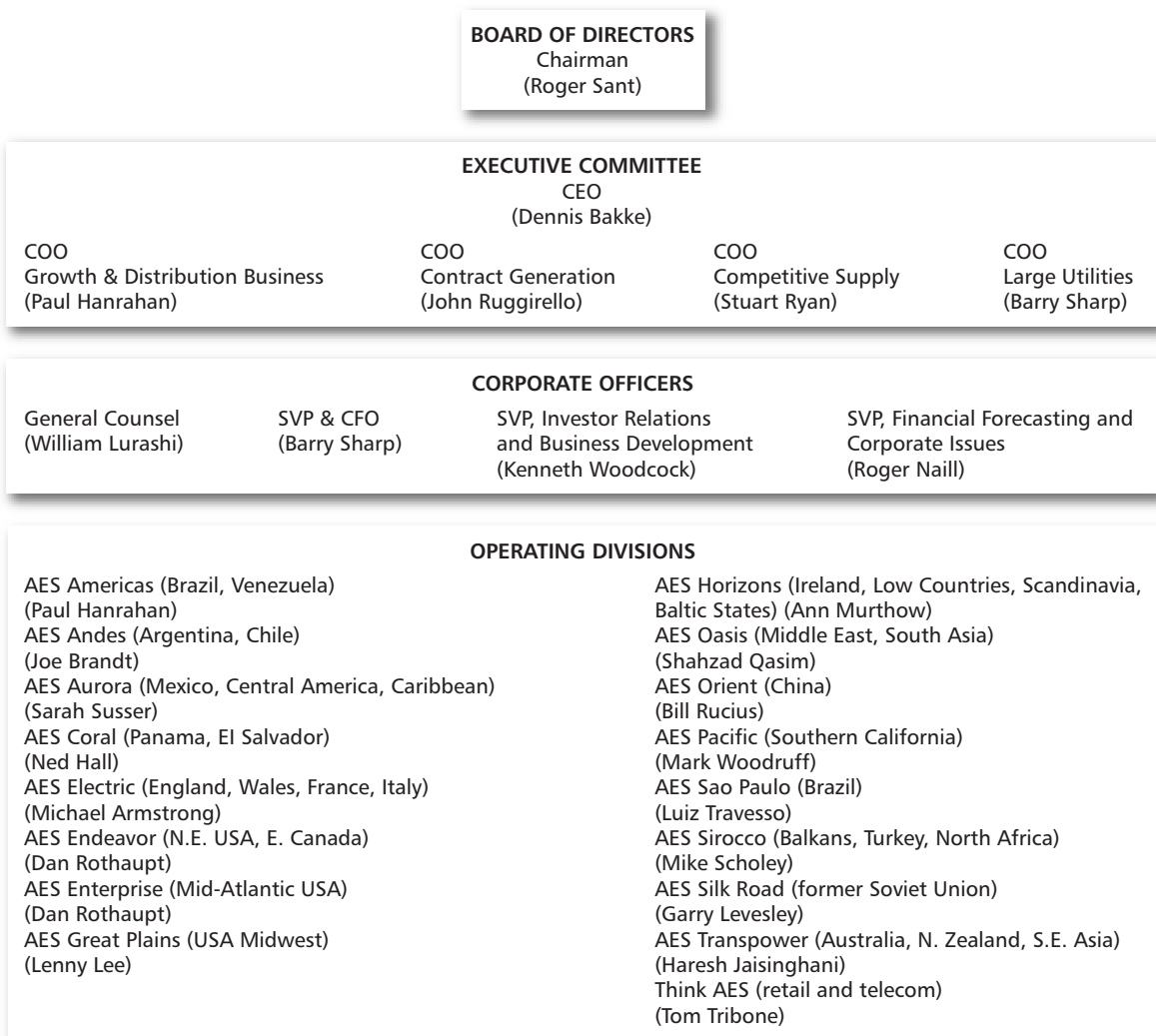
The company did not have a legal, human resources, or any other department. Decisions in such matters were made by teams at the plant level, which oftentimes had little or no experience in those decision areas. CFO Barry Sharp estimated that the company had raised \$3.5 billion to finance ten new power plants, but he was personally responsible for raising only \$300 million of that sum. The rest was secured by decentralized, empowered teams. When AES raised 200 million pounds sterling (about \$350 million) to finance a joint venture in Northern Ireland, two control room operators led the team that raised the funds.¹⁰ The same went for other areas of financial management. Treasury operations were decentralized to the individual plant level, where they were performed by teams of non-specialists:

His hands still blackened from coal he has just unloaded from a barge, Jeff Hatch picks up the phone and calls his favorite broker. “What kind of rate can you give me for \$10 million at 30 days?” he asks the agent, who handles Treasury bills. “Only 6.09? But I just got a 6.13 quote from Chase.”

In another room, Joe Oddo is working on J. P. Morgan & Co. “6.15 at 30 days?” confirms Oddo, a maintenance technician at AES Corp.’s power plant here. “I’ll get right back to you.”

Members of an ad hoc team that manage a \$33 million plant investment fund, Messrs. Oddo and Hatch quickly confer with their associates, then close the deal. “It’s like playing Monopoly,” Mr. Oddo says as he heads off to fix a leaky valve in the boiler room, “Only the money’s real.”¹¹

Similarly, there was no human resources department. At the corporate level there were no staff specialists dealing with salary ranges, or annual review procedures, or personnel policies, or contract negotiations with unions. There was a person whose responsibility was to track 401k retirement plan benefits and send out the necessary reports, but that was about it at the corporate level. Everything else was devolved to the individual divisions, and within these it was the teams within each plant that handled almost all the human resource functions.

FIGURE 19.1 AES's company structure

SOURCE: AES, 10-K REPORT, 2001.

The company operated without written policies or procedures. Issues such as hiring practices, leave periods, and promotion criteria, which in more conventional companies would be spelled out in a “Policies and Procedures” handbook, were left at the employees’ discretion. When trying to find out how much time she could take off after the birth of her daughter, a Project Director for AES Puerto Rico discovered that the company did not have a policy about maternity leave. After investigating what other “AES people” had done, she decided to do what made sense for both herself and the business requirements of the project. In the end she decided to take three months, but she made herself available at critical points in the project’s execution.¹²

Virtually all human resource decisions were made at plant level, and, within the plant, decision-making authority was located among the different teams. For example:

- *Recruiting.* The recruiting process was done at the plant level, without any support or guidelines from corporate headquarters. AES people at all levels were committed to the hiring process, and everyone could participate in it. The process generally involved an initial résumé review, and a phone interview followed by a group interview. Interviews usually did not include technical questions. Instead, they focused on characteristics that helped determine how the candidate would fit with the company's culture and values. There was little importance given to the candidates' educational background or experience, as greater emphasis was placed on the candidates' desire to learn, contribute, and grow, as well as their personal values and self-motivation.
- *Training and development.* In line with corporate values, AES employees were empowered to make decisions about their own development. Training was mostly done on-the-job, through open communication channels and embedded advice-seeking practices. However, AES people were free to take outside classes and they were reimbursed for them, as long as the courses were work-related.
- *Career paths.* Regarding development, there were no established career paths. Rather, the company encouraged flexibility, which was a necessary requirement in such a dynamic industry. Because one of the company's shared values was to "have fun," employees were encouraged to move within the company if they felt their current assignment was "boring." Job vacancies were always posted and promotion decisions were made at an area superintendent's meeting.
- *Compensation and benefits.* AES did not have a set salary schedule for any given job, and salaries were determined based on what others were being paid inside and outside the company. Raises were given every year and superintendents usually determined them in an annual meeting. Most AES people put their retirement savings in company stock, and the company matched up to 5% of the person's salary in the retirement plan.

This emphasis on multi-functionalism was central to AES's concept of making work fun. The key was to make people's work fulfilling by continually providing challenges and learning experiences. Moreover, argued Bakke, specialization did not promote efficiency or better decision making: "As soon as you have a specialist who's very good, then everyone else quits thinking," Bakke said. "The better that person is, the worse it is for the organization. The information goes through the specialist, so all the education is to the person who knows the most."¹³

Moreover, AES relied heavily on outside expertise. A key aspect of the system of empowerment was that individuals and teams were encouraged to seek out the best advice available, whether it was within the company or outside. In relation to finance, while AES's financial management and project management teams lacked great depth in financial expertise, they drew upon the knowledge of bankers and financiers. In any event, Bakke's view was that most management expertise, whether functionally specialized or general management skill, was not inherently difficult. Motivation,

attitude, and a willingness to learn were more important determinants of ultimate performance.

Decentralized decision making and lack of functional expertise meant that AES frequently made mistakes – sometimes big ones. AES’s experience in the former Soviet republic of Georgia displayed an inability to appreciate the implications of Georgia’s political or criminal environment. The result was a \$300 million loss for AES.¹⁴ AES also experienced dire government relations in Hungary.

The “Honeycomb”

AES referred to its organizational structure as a “honeycomb.” The idea was that each plant comprised a number of small, flexible, self-managed teams who were able to operate cooperatively and efficiently without any centralized direction. At the basis of this structure was the belief that organizations did not need to be managed. Thinking, motivated people could manage themselves and undertake the communication and mutual adjustment needed to coordinate complex tasks. According to Dennis Bakke, the key to effective decentralization was keeping the basic units of organization small:

I think of AES as a conglomeration of small communities. And I don’t think there’s any company in the world that’s so big that you can’t organize this way. Even a plant with 400 people can be broken down into smaller groups. It’s a small enough community that there is the ability to have an accountability structure within it, you know, a social structure as opposed to a military structure. We will break down the Kazakhstan plant into four units. How can we stay small and be big? By breaking the organization into groups with chief operating officers.¹⁵

The principle of self-organization imposed a very different role on managers from the conventional management model. Indeed, the term “manager” was seldom heard within AES; it was at odds with the principle of letting people decide for themselves. The example came from the top. “The most difficult thing for me as CEO,” confided Bakke, “is not to make decisions.” If individuals were to develop, they must be given responsibility and be allowed to learn:

[T]he modern manager is supposed to ask his people for advice and then make a decision. But at AES, each decision is made by a person and a team. Their job is to get advice from me and from anybody else they think it’s necessary to get advice from. And then they make the decision. We do that even with the budget. We make very few decisions here [indicating the headquarters office]. We affirm decisions.¹⁶

Sant made similar observations:

If Dennis and I had to lead everything, we couldn’t have grown as much as we have. People would bring deals for us to approve, and we would have a huge bottleneck. We’ve shifted to giving advice rather than giving approval. And we’ve moved ahead much faster than we would have otherwise.¹⁷

One consequence of this approach was the small size of AES’s corporate headquarters. At any point in time there might be between 40 and 70 AES employees at the Arlington office, but in terms of actual corporate staff, these numbered only about 35.

In terms of performance, one of the most important advantages of the AES system was that it permitted speed in decision making, preparing bids, and completing projects. AES abounded with a folk history of teams and individuals given huge responsibilities or thrust into unique and unexpected situations. Consider the following:

- Oscar Prieto, a chemical engineer with two years' experience with AES, was visiting AES headquarters in May 1996 when he was asked by Thomas Tribone to join a meeting: "I've got 14 people from France and some guys from Houston coming to talk about buying a business in Rio de Janeiro. We've only got two AES people. Could one of you show up?" The meeting with Electricité de France and Houston Light & Power concerned a possible joint bid for one of Brazil's largest utilities, which was being privatized. Within a month, Tribone was on his way to Paris to negotiate an agreement with Electricité de France. The deal was concluded, and by 1997 Tribone had moved to Rio to become one of the utility's four directors and a key player in a succession of deals in which AES acquired a string of power plants and distribution facilities in Brazil and Argentina.
- The development of the \$404 million Warrior Run power plant in Cumberland, Maryland was undertaken by an AES team of ten people who handled all the work necessary leading up to the plant's groundbreaking in October 1995. They secured 36 different permit approvals involving about 24 regulatory agencies and arranged financing that involved tax-exempt bonds and ten lenders. At other companies, such a project would typically involve well over a hundred employees.
- Scott Gardner joined AES in 1992 right after graduating from Dartmouth College. Gardner joined a team developing a \$200 million cogeneration plant in San Francisco. "It involved a lot of work and few people to do it," he says. "I took on tasks that ranged from designing a water system to negotiating with the community to buying and selling pollution credits." Gardner also helped lead a bid for a \$225 million cogeneration plant in Vancouver, British Columbia. When a comparable deal emerged in Australia, Gardner volunteered for that assignment. Two weeks later, he was on his way to Brisbane. "My task was to understand an unfamiliar regional power system, develop a design for the plant, and prepare a financial and technical bid document – all in six weeks," he says. When Gardner's proposal made the final round of competition, his division manager had him negotiate the terms of the \$75 million deal. "The stress was incredible, but I was having fun," he says. His bid won. "I held a press conference and was interviewed by local TV stations," says Gardner, who has since left AES to attend business school. "I had to pinch myself to be sure this was happening."¹⁸
- Paul Burdick, a mechanical engineer, had only been at AES briefly when he was asked to purchase \$1 billion in coal. "I'd never negotiated anything before, save for a used car," he said. Burdick spent three weeks asking questions of people both within and outside of the company on how to accomplish the task. At AES, he says, "You're given a lot of leeway and a lot of rope. You can use it to climb or you can hang yourself."¹⁹
- Ann Murtlow, a chemical engineer with no experience in pollution abatement, was given the job of buying air-pollution credits. She had already purchased

the option to buy \$1 million in credits when she discovered that the option she had bought was for the wrong kind of credit and useless to AES.

The Relationship with Employees

The AES principles and its concept of the honeycomb organization implied a different type of relationship between those employed and the corporation than that which characterized most companies. To begin with, the absence of functional specialists and the ideas about self-organization required a tremendous amount of information-sharing. According to the company, employees were given full access to the company's operating and financial information. Because of the extent of employee access to information that would normally be confidential at other companies, AES listed all its employees as "insiders" in its submissions to the SEC.

One of AES's crusades was to eliminate the distinction between salaried and hourly paid employees and to put all employees on a salaried basis. The 1997 Annual Report stated the goal of eliminating hourly payment systems. By the end of 1998 considerable progress had been made with more than half of AES's US employees salaried – despite the restrictions imposed by Federal health and safety legislation which perpetuated staff/worker distinctions. The primacy that AES accords its "people," as the company refers to its employees, was emphasized by its practice of listing every employee's name in the back of the AES Annual Report. However, once AES's total employment passed the 6,000 mark, this was no longer feasible.

AES and the Environment

AES's deep commitment to the environment extended well beyond Chairman Sant's personal involvement in environmentalist issues and his active roles in the World Wide Fund for Nature and as a member of the Environmental Defense Fund. AES used forestation to compensate for the emissions it generated. When the company constructed a coal-fired plant in Montville, Connecticut, it calculated that it would generate 15 million tons of carbon dioxide over its estimated life of 40 years. It devised a scheme to plant 52 million trees in Guatemala to offset these emissions. According to AES Executive Vice-President Robert F. Hemphill: "Making electric power historically has had a relatively high level of environmental assault. We are not planting trees as part of our strategy to make us a more valuable company, we're doing it because we think it's a responsible thing to do." AES's average company-wide emission levels were 40–60% of permitted rates.²⁰

The Challenge of Multiculturalism

As more and more of AES's business became located outside the US, and non-US citizens far outnumbered US citizens among AES's employees, an increasingly important challenge was to retain AES's culture as the company grew. The company acknowledged that even the stated value of having fun was difficult to accomplish with so many people with many different backgrounds. By the end of the 1990s, fewer than 8% of AES people were native English speakers. The principles of equality, teamwork, empowerment, and individual initiative were also likely to be more difficult to implement in traditional Islamic societies such as Pakistan, and countries with a socialist heritage such as China, Kazakhstan, Ukraine, and Georgia.

Nevertheless, AES remained committed to its principles not just for its US concerns, but for all its worldwide operations. Bakke firmly believed that the AES principles were universal and were not culturally specific either to the US or to the West in general. AES's experience was that its own corporate culture could be transplanted in many different national cultures. The challenges presented in running one of the world's biggest (and once one of the most dilapidated) coal-fired power stations in Kazakhstan, and turning around heavily bureaucratized, former state-owned utilities in South America provided remarkable test-cases in AES's ability to export its company culture. The results were often amazing. Even though AES was unable to eliminate the distinction between salaried and hourly paid employees within the US, in England, Argentina, and Pakistan it moved to an all-salary workforce.

Instilling the AES culture into the 100-year-old Light Servicios de Electricidade involved, first, a generous severance package to cut the workforce by half, second, the careful selection of young, motivated engineers and supervisors to take key positions as facility supervisors, and finally, the devolving of decision-making power to them. At Light's Santa Branca facility, Oscar Prieto chose Carlos Baldi, a 34-year-old engineer, to lead the plant. "I knew he was the right person," says Prieto, "He was young, eager to do more." After agreeing to shared goals and expectations – zero accidents, thrifty construction budgets – Prieto turned Santa Branca and a \$35 million upgrading project over to Baldi. After a short while, Baldi was managing in the same way with his project and team leaders.²¹

2002: Retrenchment and Restructuring

During the first quarter of 2002, CEO Dennis Bakke was forced to shift his attention from the issues that most interested him – AES's ability to maintain its values and live its principles – to address the fallout from Enron, Argentina, Venezuela, September 11, and the California power crisis that were devastating AES's share price. On February 20, AES announced a major shift of strategy. In the expectation that AES would be unable to access the capital markets in 2002 for additional borrowing, it would be forced to rely on its internally generated cash flows to fund operations and capital expenditures. Retrenchment measures included: reducing capital spending by \$490 million in 2002, selling several existing businesses, and withdrawing from its merchant generation businesses.²² However, several analysts were doubtful as to AES's ability to command a fair value for the assets it was putting up for sale. In a note to clients, Ronald Barone of UBS Warburg wrote: "The markets in which AES operates are depressed and there are a number of other companies that are already looking to dispose of similar assets."

Bakke recognized the seriousness of AES's situation: he opened his conference call to analysts with the simple statement: "Our world has changed." In the accompanying press release he stated: "We are taking aggressive action to restructure and de-leverage AES. Given today's market climate we are going to rely on the cash flows of our solid operating businesses. We have taken additional steps to provide a more substantial liquidity cushion. We believe the actions we have announced will provide for a more conservative business model."

Under pressure from the board of directors, Bakke was forced to make organizational changes. An executive office was created comprising Bakke as CEO together with four newly created chief operating officers – each with responsibility for one of

AES's four lines of business. The reorganization was intended to: "enhance operating performance, including further reductions of operating costs and revenue enhancements . . . Each COO is directly responsible for managing a portion of the Company's geographically dispersed businesses as well as coordinating Company-wide efforts associated with one of the Company's business segments. In addition, two special offices, the Cost Cutting Office and the Turnaround Office, have been created to bring improved focus and coordination to the management of expenses across the Company and to improve or dispose of businesses that AES believes to be under-performing businesses from a return on capital perspective, respectively. Each of these offices reports to the Executive Office."²³

The new emphasis on financial control and centralization of decision making conflicted directly with AES values and management principles. But how far did it mean an irreversible rejection of the management model that Bakke and Sant had created at AES? The circumstances affecting AES in 2002 were a "perfect storm" of coincidental adversities: Enron, the California energy crisis, 9/11, the collapse of UK electricity prices, and instability in several of the countries where AES did business – Argentina, Venezuela, and Pakistan. Inevitably AES would have to downplay "integrity, fairness, fun, and social responsibility" while it weathered short-term turbulence. But what about the longer term? The pressure that the AES board had come under from investors and banks demonstrated that the financial community was tolerant of AES's radical approach to management only when its share price was buoyant. But even without this pressure, how realistic was it for AES to maintain its informal, principles-based approach to management in a company that was a multinational employing almost 40,000 people?

Moreover AES's industry environment had changed. Not only was competitive pressure intensifying, but the basis of competition was shifting. In a tougher competitive environment, operational efficiency and entrepreneurial zeal were no longer enough; sophisticated financial structuring, risk management, and government relations expertise were increasingly important. These capabilities tended to be associated with functional experts at head office rather than with task forces comprising front-line employees. AES's unique organizational structure, management systems, and corporate culture had shown themselves to be highly effective both in the efficient operation of power stations and in supporting the entrepreneurial capabilities required for winning power supply contracts all over the world. Moreover, because of its very low rate of employee turnover and open internal communication, it has been very effective in retaining this expertise and sharing it internally. Looking ahead, a critical question was whether AES's management philosophy and methods had reached the limits of their effectiveness and henceforth AES would need to replace its emphasis on fun and social responsibility with a more conventional approach.

Notes

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- 2 "Arlington's AES Corp. leads a battery of US energy companies overseas," *Washington Post*, May 22, 1995.
- 3 "The principles behind its power," *Washington Post*, November 2, 1998, p. F12.
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- 5 Dennis W. Bakke, "Erecting a grid for ethical power," *The Marketplace*, May/June 1996, p. 5.
- 6 AES Corporation, 10-K Report for 2001.
- 7 Personal meeting, April 2000.
- 8 Dennis Bakke and Roger Sant, Annual Letter to Shareholders, 1997 *AES Corporation Annual Report*.
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- 10 Alex Markels, "Power to people," *Fast Company*, 13 (March 1998), p. 155.
- 11 *Wall Street Journal*, July 3, 1995, op. cit.
- 12 Jeffrey Pfeffer, "Human resources at the AES Corporation: the case of the missing department," Graduate School of Business, Stanford University, 1997, p. 14.
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- 14 W. J. Henisz and B. A. Zelner, "AES-Telasi," Wharton case study, 2006.
- 15 Jeffrey Pfeffer, op. cit., p. 14.
- 16 "The power of a team: Arlington's AES Corporation," *The Washington Post*, February 12, 1996, p. F12.
- 17 Alex Markels, op. cit., p. 160.
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- 19 *Wall Street Journal*, July 3, 1995, op. cit.
- 20 "Power plant builder tries to reenergize environmental image," *The Washington Post*, July 6, 1992, p. F1.
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AirAsia: The World's Lowest Cost Airline

TEACHING NOTE

■ SYNOPSIS ■

The Malaysian airline AirAsia was an entrepreneurial venture started by Tony Fernandes, a Malaysian music executive who was inspired by the example of easyJet's Stelios Haji-Ioannou. From just three planes flying out of Kuala Lumpur, by 2009 AirAsia had six hubs Kuala Lumpur (Malaysia), Johor Bahru (Malaysia), Bangkok (Thailand), Jakarta (Indonesia), Kuching (East Malaysia) and Kota Kinabalu (East Malaysia). In 2007, AirAsia achieved the distinction of being recognized the world's lowest cost airline in terms of operating cost per available seat-kilometer (ASK): the industry's main benchmark for cost efficiency). AirAsia's costs were between 25% and 45% below those of Ryanair, Southwest, JetBlue and Virgin Blue.

The case explores the sources of AirAsia's cost efficiency by outlining the main features of AirAsia's strategy and operations and comparing it with its Malaysian rival, Malaysian Airline System, the country's national carrier.

The case also considers a major departure from the business model pioneered by Southwest and Ryanair. AirAsia has expanded into long-haul flights through its sister company, AirAsiaX. Although AirAsia appears to be a cost leader on its Kuala Lumpur to London route, combining long-haul and short-haul flights risks compromising the simplicity and consistency of AirAsia's business model.

■ TEACHING OBJECTIVES ■

The case allows a fairly straightforward application of the tools of cost analysis (Chapter 7 of *Contemporary Strategy Analysis*) to an industry where inter-firm cost and efficiency comparisons are comparatively easy. The case offers an alternative to other cases whose primary focus is the strategies of the low-cost carriers (e.g. cases on Southwest airlines, Ryanair, and easyJet).

One of the key learnings from the case is that cost efficiency is not simply the result of low-cost inputs, operational design, and economies of scale and learning. As other cost leaders, such as Southwest Airlines and Wal-Mart, clearly demonstrate, maintaining cost leadership is highly dependent upon a corporate culture and management style which encourages the principles of parsimony and cost reduction to be internalized by employees and the creation of a company environment where cost reduction is a never-ending quest that involves everyone in the company.

The case also demonstrates the fact that a strategy of cost leadership does not necessarily imply a commodity product or a lack of differentiation. As Southwest has clearly demonstrated, a low cost strategy is quite consistent with offering the traveler a pleasurable and problem free travel experience.

■ POSITION IN THE COURSE ■

This is a case in competitive advantage with specific reference to cost advantage it fits with the part of the course dealing with business strategies to create competitive advantage.

■ ASSIGNMENT QUESTIONS ■

- What are the sources of AirAsia's cost advantage?
- Should AirAsia expand its long haul business and to what extent should AirAsia and AirAsiaX be integrated operationally?

■ READING ■

R. M. Grant, *Contemporary Strategy Analysis* (8th edn.), Wiley, 2013, Chapter 7.

■ CASE DISCUSSION AND ANALYSIS ■

What are the sources of AirAsia's cost advantage?

In analyzing AirAsia's cost advantage a preliminary issue to decide cost advantage in relation to which other companies? AirAsia has lower costs than other low cost carriers (LCCs) such as Southwest and Ryanair. It also has lower costs than its main local rival, Malaysian Airlines (MAS). Given that AirAsia is not competing against Southwest and Ryanair, comparing its costs with those of its most direct competitor is most appropriate (also this avoids issues of exchange rates).

Having decided to benchmark costs against MAS, the next question I pose is: "What is the key indicator of an airline's cost efficiency?" Students should be able to identify *cost per available seat kilometer* as the main cost indicator, i.e. the cost of flying one passenger, one kilometer. As Table 1 shows, the difference is considerable:

AirAsia 11.66 sen	MAS 22.80 sen ¹
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When asked about the sources of this cost difference, students typically focus upon the LCC operating model. I press the class to identify the key elements of this and explain why each element results in a cost advantage. Among the key points here are:

- Point-to-point travel: avoids complexities of through ticketing and baggage transfer. Also consistent with single aircraft type.
- Use of secondary airports. Major cost savings in landing fees and passenger handling charges.
- Single aircraft type: economizes on training and maintenance.
- Fast aircraft turnaround time: increases productivity of aircraft and employees
- No frills customer service: allows simplicity and facilitates fast turnaround
- Direct sales only, no use of travel agents: saves on commissions, no need for external computer reservations systems (e.g. Sabre), allows direct contact with customers
- High seat density per plane: lowers average cost per seat
- Job flexibility among employees: increases employee utilization, conducive to motivation and customer focus
- Non-union labor: cheaper, more flexible.

So, is AirAsia pursuing a generic, LCC strategy? It is interesting to note that co-founder Conor McCarthy described Air Asia's business model as: "a Ryanair operational strategy, a Southwest people strategy, and

an easyJet branding strategy.” If this does not come up in the discussion, I specifically ask one of the class, “What did McCarthy mean by this statement?”

The answer can tell us a good deal about what it takes to make the LCC strategy work—especially in a new market:

- The Ryanair operational strategy is basically what has been described above. The whole emphasis is on boosting productivity by avoiding delay and standardizing everything that can be standardized.
- The Southwest people strategy is about decentralized decision making, employee initiative, strong corporate values, and lack of hierarchy. This recognizes several important facts about the airline business:
 - Not everything can be standardized and systematized. Individual customers are different and a vast range of unpredictable events can occur—initiative and flexibility among employees allows an LCC to pursue its operational model while also adapting to unforeseen circumstances
 - Efficiency requires high levels of employee productivity. People work hard when motivated. Employee involvement and shared values encourage commitment and effort.
 - Supervising and controlling employees by managers, financial incentives and control systems is expensive; if employees accept corporate principles and are immersed in a corporate culture, these may represent low-cost mechanisms for control and inducing efforts.
- easyJet invests more in brand building than Ryanair—one consequence of which is that it is higher cost than Ryanair (see Figure 9.1). Certainly AirAsia has been a big spender on advertising, sponsorship, and other forms of promotion. So, what is the rationale for this and how does it fit with AirAsia objective of cost leadership? We need to recognize that for a start-up airline with strong growth ambitions, achieving low costs is critically dependent upon high load factors. Hence advertising and other forms of brand building can play an essential role in creating the demand necessary to achieve high levels of capacity utilization. This is particularly so in a country where air travel is unknown to a majority of the population. Because the LCC model relies upon expanding the market for air travel, marketing can play an important role in market development.

Having looked at the reasons why AirAsia’s strategy, operations management and HR management reduces its costs. It is useful to see just how far the evidence points to AirAsia’s cost leadership.

Comparing AirAsia with MAS (see Table 1) reveals the following:

Productivity indicators	AirAsia	MAS	Comments
ASKs/employee	4,942	2,796	Employee productivity substantially higher at AirAsia
ASKs/plane	0.24m	0.49	Mainly the result of MAS's bigger planes. Also fleet size is measured at year end; AirAsia was adding planes during the year
Load factor	75%	67.8%	
Plane utilization (hours/day)	11.8	11.1	AirAsia gets higher utilization despite shorter routes
Cost make-up (cost item as % of total operating cost)	AirAsia	MAS	Comments
Staff	8.0%	14.3%	Lower cost seems to be due primarily to lower pay: staff cost per employee RM 62,332 for AirAsia, RM114,167 for MAS
Depreciation	11.7%	2.2%	Reflects AirAsia's newer planes
Fuel	46.9	43.0%	Doesn't take account of AirAsia's unwinding of fuel derivatives
Maintenance	11.6%	7.5%	Probably few economies here for LLCs
Other operating costs	4.7%	33.0%	Big differences reflect differences in the two firms' business models. Note that AirAsia has no sales commissions, has lower landing fees, and has no administrative buildings

Despite AirAsia's lower operating costs compared to MAS, a striking feature of Table 1 is the fact that MAS made a net profit in 2008 while AirAsia turned in a net loss. The reasons are not difficult to detect. First, while AirAsia's cost per ASK was 49% below that of MAS, its revenue per ASK was 32% less. Second, AirAsia incurred a RM830m (US\$ 237m) charge in 2008 arising from unwinding its fuel derivatives through which it hedged against movements in the price of jet fuel. This was the result of the collapse in crude oil prices during 2008: AirAsia decided it was better to take a loss from unwinding its hedging contracts in order to benefit from lower market prices for fuel.

If time permits, it can be interesting to discuss the merits of fully hedging against oil price fluctuations. If an airline hedges fully by continuous forward contracts for its jet fuel, does this really reduce the volatility of its costs or is it simply tracking fluctuations in the spot market with a lag? The main arguments for hedging are (1) predictability—with forward contracts the firm can estimate its future costs, (2) futures prices are subject to short-term supply variations hence are less volatile than spot prices.

Expansion into Long Haul Flights

AirAsia's expansion into long-haul through AirAsiaX, its associate company appears to be part of Fernandes' vision, but is the result of admiration for budget-airline pioneer Freddy Laker rather than any well-conceived business model. The case notes that very few LCCs have attempted to combine short and medium-haul routes with long haul. To understand why, it is useful to review the points that were made concerning the cost-reducing elements of the LCC operating model.

Once an LCC adds long haul flights several elements of the model are compromised, including:

- Single aircraft type (long haul requires bigger planes)

- Use of secondary airports (smaller airports often unable to accommodate large planes)
- Fast aircraft turnaround time (not feasible with international flights)
- No frills customer service (on longer flights refreshments and in-flight entertainment essential—also additional baggage services are needed).

In addition, for international flights there is typically not the large untapped market as for domestic/regional flights—hence an LCC is probably going to have to take market share from existing international carriers.

The overall result is that the operating model for an LCC flying international routes is less distinctive from that of the established carriers. The cost advantages are smaller and it is more difficult for them to differentiate on the basis of punctuality and reliability.

Also, an LCC with a small international route network will lack the economies of scale available to a bigger international airline. It will also lack the ability to offer through-ticketing and through baggage service to a wide range of destinations (for the established airlines these network advantages are enhanced by alliances that offer code-sharing between airlines)

Hence, it is clear that the LCC potential for competitive advantage is weaker in international than in regional routes.

Despite this, the data in Table 4 suggests that AirAsia's cost advantage on the London-KL route is still substantial (a 33% cost advantage over MAS, compared to a 49% advantage in terms of cost per ASK overall).

So should AirAsia expand its AirAsiaX business and, if so, should it seek to integrate within AirAsia? Given the differences between the two business and operating models, it might be less risky to operate the two as separate airlines (a model here might be Virgin Atlantic which has no business or operational linkages with Virgin Blue or Virgin America).

■ KEY TAKE-AWAYS FROM THE CASE DISCUSSION ■

1. ***Cost drivers: identifying the sources of cost differences between firms.*** The list of *cost drivers* (see Figure 9.1 in *Contemporary Strategy Analysis*, p. 231) offers a systematic approach to identifying the reasons for differences in competing firm's unit cost. In the case of the AirAsia, the principal factors appear to be:
 - “Input Costs”—lower wage rates
 - The combination of “Product Design” and “Production Techniques”—the LCC operating model involves a combination of design of the service product (e.g. no frills, single class) plus the system through which it is provided (point-to-point, single aircraft type, fast turnaround).
 - “Residual Efficiency”—success of LCC model ultimately depends upon motivation and initiative of employees.
2. ***Role of “Residual Efficiency”*** In most cost leaders cultural, managerial, and motivational factors play a critical role in achieving and sustaining cost efficiency. Culture can play a particularly important role—if employees can internalize the values of thrift and parsimony they become key

drivers of cost reduction (as in Wal-Mart). The great virtue of corporate culture is that it is cheaper and more effective than other control devices (e.g. supervisors, financial incentives)

3. ***Cost efficiency in service businesses.*** In manufacturing industries scale economies (especially in research and new product development) tend to be key drivers of interfirm cost differences. In service industries, *economies of replication* tend to be key type of scale economy. Other critical driver is business system design (i.e. combination of product design and production techniques)
4. ***Cost leader does not necessarily mean providing a commodity product.*** Cost minimization is consistent with differentiation. Southwest and AirAsia make great efforts to make a flying a pleasant experience for travelers; Ryanair boasts Europe's best on-time record. The original models of the VW Beetle and Fiat 500 low price, mass produced cars, yet established cult status. The Tata Nano may follow in the same path.
5. ***Differentiation may be complementary to cost efficiency.*** Low cost typically requires scale efficiency and capacity utilization—differentiation in terms of appealing design, brand awareness, and reputation for quality may be needed to drive this demand. For AirAsia as for McDonalds and Hyundai, differentiation may be essential to drive the sales volume necessary for exploiting sources of cost efficiency
4. ***The sustainability of cost advantage in service industries.*** Cost advantage may be more sustainable in service industries than in manufacturing industries. Manufactured goods are tradable—hence cost advantage can be overturned by exchange rate movement or by a new entrant from a low cost country. In service industries overseas competition is typically not present and an established cost leader can pre-empt the national/regional market (Wal-Mart, McDonalds, Ryanair).

NOTE

¹ 1 sen = 1/100 of Malaysian Ringgit. In 2008, US\$ 1 = RM 3.5.