LAN TAM airlines merger: a leap of faith too far

LAN Airlines, a US$ 9 billion market value Chilean firm which annually transports 17 million passengers in both domestic and foreign markets, plus air freight - 25% of revenues -, intends to merge with TAM, a US$ 3 billion market value Brazilian airline which moves 33 million passengers per year. Both firms are dominant actors in their markets: LAN has around 80% of the domestic passenger market and 60% of the international one – in domestic air freight, 90% -, whereas TAM has 45% and 30% in passenger markets, respectively – freight sales represent 10% of revenues -. Both firms have extensive code-share agreements with other airlines in the international markets (LAN has 8; TAM, 10), including one between themselves, besides being members of airline alliances OneWorld and Star Alliance, respectively. This is one part of the story, with a relatively small cross participation and working under a cartelized airline world, IATA oriented; the main story refers to two January 2009 independent resolutions from the Chilean Competition Court (TDLC) and the US Department of Justice (DOJ) and a November 2010 European Commission fine – plus other antitrust entities pending investigations - for anticompetitive behavior, and the rarely mentioned issue of existing passenger fares, all events that took place even before this merger proposal.

To wit, on January 16th, 2009 the Chilean Competition Court basically defined the airline market as non competitive, recommended a unilateral opening of its domestic market even without reciprocity from the rest of countries and alerted about a self regulatory domestic fare plan applied to LAN - due to its overstretched domestic market participation - that dangerously depended on prices where the same dominant firm to be checked had capacity to influence, thereby losing its effective ability to limit them[1]. A different situation might have been if those maximum prices were to originate from more competitive markets unrelated to the dominant firm strategies, as the domestic US airline market could be.

On the other hand, on January 21st, 2009 LAN Cargo announced that it had reached a plea agreement with the DOJ in relation to the DOJ´s ongoing investigation regarding price fixing of fuel surcharges and other fees for cargo shipments, agreeing to pay a US$ 109 million fine, the biggest ever fine applied to a Chilean firm for this reason. It so happens that 4 out of the 8 firms with which LAN code-shares have also pled guilty under this price fixing investigation[2]. The Brazilian, Korean and New Zealand antitrust authorities are also investigating related events. Last November, the European Commission fined 11 cargo carriers – including LAN and 3 code sharers - for operating a worldwide price fixing cartel over a six year period[3]. Moreover, the list of anticompetitive proceedings against LAN in Chile is long, particularly since its 1995 merger with Ladeco that allowed it to double its domestic market share to 80%.

---

[1] Requerimiento de la FNE contra la Junta de Aeronáutica Civil , TDLC, 16 de enero 2009

[2] LAN Cargo, Aerolinhas Brasileiras SA and El Al Israel Airlines Ltd. agree to plead guilty for fixing prices on air cargo shipments, US Department of Justice, January 22nd, 2009

[3] Europa, Antitrust: Commission fines 11 cargo carriers e799 million in price fixing cartel, Brussels, Nov 9th, 2010

As for passenger fares, information is tellingly poor. On domestic routes - mostly Chilean and Peruvian, where LAN has an 80% market share – tariffs per km were 1.33, 1.55, 1.49, 1.37 and 1.43 times domestic US tariffs for the period 2004 to 2008, with a shorter average distance in our domestic market – 900 km vs. 1.400 km -. On international routes, the figures were 0.98, 1.02, 1.04, 1.05 and 1.16 respectively, but noticeably with an even larger LAN average distance around 3.700 km. The above figures point to an excess price from LAN but its magnitude varies along time and market. As a reminder, the American airline market transported close to 720 million passengers last year, more than double its 310 million inhabitants, under negligible fatalities – 69 in 2009, for example -. While Chile has also no fatalities to report, it had an 11 million passenger movement out of a 17 million population[4].

In other words, here we have a publicly known concerned Competition Court and a history of uncompetitive domestic behavior that has gone beyond our borders, accompanied with more expensive passenger fares. It is under this yet unsolved non competitive Chilean scenario where a merger is now being proposed, making it even harder to challenge the dominant airline wherever it operates. As a matter of prudence, a rejection is due, unless the Competition Court opinion is seriously put into law and its implementation faces no obstruction from the incumbent. Furthermore, legislative and executive branches should induce a more competitive airline market whether or not this merger proposal goes on. Besides, a competitive solution where it should exist will always be preferable to fixing prices as it would happen in a "natural monopoly" case where for non economic reasons a firm gets closer to its nature.

The best way to start a feasible and long term solution would be with the US, opening Chilean markets without reciprocity. This country already has an operating Free Trade Agreement with the US - which regrettably missed financial services but which could also be opened this way - and an Open Skies Agreement. This last one would then allow any US carrier to directly operate in the domestic Chilean market and in its allocation of international route rights. Being DOT (US Department of Transportation) and FAA (US Federal Aviation Administration) approved should suffice for a carrier from there to operate inside Chile and in its international route rights network. American carriers interested in the Latin American market would provide the scale, service and frequent flier programs that would compete with LAN or even a potential LAN TAM merged company. The solution would be permanent and born out of a more competitive and dynamic market and not reliant on promises from the incumbent to acquiesce to certain short term restrictions on prices, slots or capacity on some few routes as it shows in its proposed plan with the Antitrust Attorney Agency (FNE)[5]. The solution would have to be much more stronger than that, intrinsically competitive and not dependent on US, EC or Chilean antitrust authorities working under a continuum of proceedings against the incumbent nor on the goodwill of a firm that has built its business on the continuation of imperfect markets along good managerial skills.

---

[4] See US Bureau of Transportation Statistics, LAN Forms 20 –F presented to SEC and JAC-Chile statistics.

[5] Acuerdo Extrajudicial LAN FNE, TDLC, 27 enero 2011

Opening our foreign trade in goods without reciprocity changed Chile for the better in the 1970´s. The financial and the airline markets remain living in the past and the price of reciprocity has been too high to obviate it. US President Obama visits Chile next March: besides nuclear energy developments, financial and airline markets unilateral openings could start a new development trend in this country that would be certainly followed by others suffering from the same entrenched domestic oligopolies, with clear impacts on living standards and a reinforced signaling on the need of competitive markets.

Manuel Cruzat Valdés

Santiago, Chile
February 8th, 2011