Latam Airlines under a competitive market?

On September 21st, 2011 the Chilean Competition Court (TDLC) approved, with conditions, the merger between LAN and TAM airlines. These conditions were set so as to enable the emergence of at least a second airline network in South America that could put a competitive pressure to the newly born one. The decision was not unanimous and the minority vote explicitly rejected the merger proposal and asked for additional measures, including among others, a unilateral opening of skies to domestic air travelling, particularly shared by all members of the Court. Controlling both three fourths of the domestic market in Chile and flights to and from Chile to countries in South America, where most Chilean international travelers went, even under certain restrictive conditions from the Court, was predictably to prove damaging to consumers for there would not be in place effective competitive incentives to share "synergies" out of the merger with them, notwithstanding multiple promises.

It was a mistaken and perhaps naïve decision from the Court which did not decide to return to a competitive state of affairs but just to "protect" the then imperfectly competitive environment from further worsening due to the merger.

One of the arguments raised by LAN, given at late stages of the process as if then recently discovered, was that it offered cheaper tariffs than competitive markets such as those existing in the US. The Court duly rejected those claims explaining the situation was exactly the opposite and strongly criticized the incumbent firm for delivering unreliable tariff information before and during the approval process.

As of today, LATAM airlines, the merged company, is increasing its capital by almost US$ 1 billion[1]. Its annual sales are close to US$ 13.3 billion and its market capitalization is around US$ 7.5 billion or 60% of pre-merger market values. The merging process has been unexpectedly hard to implement and in the longer term "synergies" are expected to be between US$ 600 and US$ 700 million per year. The list of selling points in the present public offering includes participation of 50% in intra-regional flights, strong international alliances – One World, code-sharing agreement with American Airlines -, being a leading player in three (Brazil, Chile and Peru) out of the six domestic markets in which it has operations and which together represent over 90% of total traffic in Latin America and having sales three times the next competitor – Avianca Taca – and twice its fleet, among others. How the Court imagined an effective competition against this company in South America and particularly in Chile is difficult to fathom.

What is interesting is the declaration[2] made by LATAM Airlines to the SEC in the US when it now refers to domestic Chilean aviation industry risks. It says: *"Chile may open its domestic aviation industry to foreign airlines without restrictions, which may change the competitive landscape of the domestic Chilean aviation sector and affect our business and results of operations"*, thereby describing steps taken by both the Secretary of Transportation and Economics towards unilateral opening of domestic skies. It concludes: ***"Competition from international carriers in the Chilean market may affect the competitive dynamics of our industry by reducing our passenger traffic and cargo demands, forcing us to reduce***

[1] See "Presentación Road Show LATAM Airlines Noviembre - Diciembre 2013".
[2] See LATAM Airlines, SEC US, Form 20 F on April 30th, 2013 and Form 6 K on November 18th, 2013, section "Risks related to our Operations and the Airline Industry".

***our fare levels, which could have a material adverse effect on our revenues and levels of operations”*.** In other words, a non competitive domestic environment clearly prevailed at the time of approval, and still does. A surprising statement from a company that tried to convince the Court it worked under competitive domestic conditions delivering prices even lower than in the US. **What the Chilean Competition Court could not then get acknowledged from LAN and TAM the US SEC is now given.**

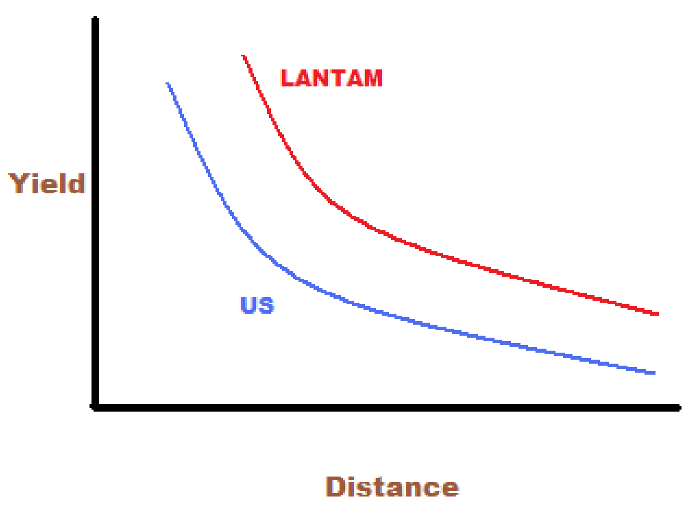
From the same Form 20 F the following ensues:

Passenger yield (passenger revenues / RPKs, in US cents)			
	LATAM 2012	LATAM 2011	LAN 2010
International	9.3	9.4	8.7
average length of haul km	*4,039*	*4,173*	*3,685*
Domestic	12.2	13.3	10.8
average length of haul km	*967*	*952*	*902*

The equivalent figures for the domestic passenger market in the US, for years 2010 and 2011, from the US Department of Transportation and measured in the same units are the following:

Passenger yield (passenger revenues / RPKs, in US cents)			
US Domestic air carrier passenger			
	2012	2011	2010
Domestic	n.a.	8.63	8.07
average length of haul km	n.a.	*1,850*	*1,861*

It might be useful to remind that there is an inverse relationship between passenger yields and traveled distance because of fixed operating and capital costs that get more evenly distributed per km as traveled distances increase. In other words, if competitive markets did exist, US yields – for a distance of 1.850 km - should be ***bigger*** than international LANTAM yields – 3.600 to 4.100 km -, a fact which does ***not*** occur. It just happens that LANTAM operates under a higher yield curve for every distance compared to a competitive market such as US´s.



Furthermore, while the merger approval process was being discussed between the end of 2010 and the end of 2011 US yields increased by 6.9% under constant distance whereas LATAM prices increased by 8% in international flights and 23% in domestic flights, even under ***increased*** flight distances by 13% and 5% respectively - which should have put a downward pressure on yields, exactly contrary to what was observed -. In other words, for constant distances LANTAM yields increased by more than 8% and 23% for international and domestic flights respectively in one very particular year, from 2010 to 2011.

In absolute terms, the price mark up from LANTAM relative to a competitive market is clearly over 10% and could reach 50% along the curve if above mentioned figures were considered. Certainly a short sampling period, but equivalent indications of this pattern as to the real non competitive picture were available before the Court decision, not to say repetitive collusive and uncompetitive conducts already known and penalized. It is just noteworthy that during the same period the merger was being discussed prices were being lifted beyond general cost conditions, as reflected from the US market. Such is the power of an oligopolistic leader whose competitors naturally privilege adjustment over challenge.

At present day, the merger is a fact and so far “synergies” have been pretty elusive and mark up pricing pretty effective. The Court and transport authorities in Chile and in other Latin American countries should be permanently proactive to make the market more competitive and enable effective air network alternatives. It will be just more difficult to get there. That is the price for mistakes and the merger approval was regrettably a big one, with consequences that go beyond Chile. The minority vote was right.

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