AIRLINE COMPETITION

-- Note by Chile --

18-19 June 2014

This note is submitted by Chile to the Competition Committee FOR DISCUSSION under Item IX of the agenda at its forthcoming meeting to be held on 18-19 June 2014.
INITIAL CONSIDERATIONS ON THE STRUCTURE
OF THE AIRLINE SECTOR IN CHILE

1. The airline sector has been subject of a number of cases, which have been investigated and decided by the Chilean competition authorities, the National Economic Prosecutor's Office (FNE or Fiscalía Nacional Económica) and the Competition Tribunal (TDLC or Tribunal de Defensa de la Libre Competencia). These cases refer to activities directly related to airlines, namely air transport for passengers and freight, as well as a number of secondary activities undertaken by airlines, such as ticket selling, or others that directly affect competition in the sector, such as airport facilities and open skies policies.

2. The diversity of investigated matters in this sector by the FNE stems partly from the diversity of activities of the main incumbent and its subsidiaries operating in the Chilean airspace. The LAN Group\(^1\) consists of a number of companies such as LAN Cargo -in charge of freight transport-, LAN Express and LAN Chile -responsible for passenger transport-, and others. It also owns a web platform for ticket selling and several offices across Chile that operate in a similar fashion as traditional travel agencies.

3. For each area of activity that has been analyzed, relevant markets have been defined, taking into consideration both demand and supply factors. Particularly, for air passenger transport, the relevant market has been defined as the combination of city pairs (origin and destination). Based on analysis of demand side substitutability, the FNE in general has not considered stop-over flights, or other modes of transport -mainly ground transport or charter flights- to belong to the same relevant market as direct flights. The factors taken into consideration for the definition of the relevant market include journey duration, cost and passengers’ time sensitivity.

4. In 2011, when the LAN-TAM merger was studied by the TDLC, a second relevant market analysis was also taken into consideration. Given that the resulting merged company -LATAM- was going to be a relevant actor in the South American air market, competition among airlines in this level -and even competition among different airline alliances- was also taken into consideration.

5. Considering freight transport, the relevant market has been defined on a country by country basis. It is worth noting that unlike the passenger transport market, direct and indirect flights have been considered as part of the same relevant market, given that, generally speaking, freight can be transported with one or more intermediate stops. Nonetheless, the FNE finds that -consistent with the analysis of passenger services-, other modes of transport are not substitutes to freight air transport.

6. The market structure differs considerably between national and international routes and services. As a result, the conducts investigated for each of these markets have also varied. In what follows a brief review of the national and international services structure and cases is included, aiming to provide a better understanding of the airline sector in Chile.

\(^1\) Today’s LATAM, after the Merger with TAM Airlines.
1. **National Services**

7. The national air transport industry in Chile has been dominated by the presence of the LAN Group -currently part of LATAM-, (LAN Airlines and its subsidiary LAN Express), which in 2013 held 76% of the passenger air traffic and 88% of the national freight traffic.2

8. In 1994, the Chilean airline market consisted of 3 local airlines: LAN, Ladeco and National. LAN and Ladeco had a joint market share of around 85% of national flights, which in turn accounted for roughly 25% of the total income of these two airlines.

9. LAN and Ladeco voluntarily inquired for merger clearance before the Preventative Commission (the “first tier” of the TDLC’s predecessors); their main justification for the merger was to gain the ability of competing in the international routes market from a stronger position, considering the economies of scale that the merger would generate, the scarcity of air liberties -that would no longer have to be shared between these two companies-, and the fact that most of the international competitors were flagship carriers that had governmental participation. LAN also proposed applying a self-regulation plan, in order to prevent price increases in national routes. Clearance was denied by the Commission, based on the appreciation that competition in the national market would be hindered.

10. The companies challenged this decision before the Resolutive Commission (the “second tier” of the TDLC’s predecessors), stating that competition from the third Chilean airline -National-, and the contestability of the airline market, would prevent abuses of a dominant position in national routes.

11. The Resolutive Commission considered that the domestic airline market was competitive, operated under conditions of openness, transparency and deregulation, and was going through an expansion phase; all these conditions would favor competition in the market after the proposed merger. It also stated that the merger of LAN and Ladeco would originate scale economies, which would improve the efficiency of the merged company, and also generate cost reductions, which should be passed through to lower prices.

12. After taking these considerations into account, the Commission approved the proposed merger with the following condition: the company needed to submit itself to a rate self-regulation regime. This regime contemplates 2 types of markets in national routes: (i) competitive markets, defined as those routes in which an airline other than LAN-Ladeco offers at least one daily trip, and (ii) non-competitive markets, defined as routes in which LAN-Ladeco is the only airline. Under the self-regulation regime, LAN-Ladeco’s average rate in non-competitive routes cannot be higher than the average rate charged in the same period in competitive markets with similar routes.

13. After this decision, the self-regulation plan has been adjusted and perfected several times. However, the main principles behind this regime have not changed.

14. Since the establishment of the first Self-Regulation Plan, the FNE has initiated a number of investigations, some of them as part of its regular monitoring of the sector and others after third parties’ complaints for alleged anticompetitive actions in specific national routes. In recent years, all investigations

---

referring to the Self-Regulation Plan have been finalized without any further action taken, due to the fact that in no occasion did the data on routes, tariffs and frequencies confirm any breach of the Plan.\(^3\)

15. The last of such complaints was made in 2012 by two members of the Chilean Chamber of Representatives, who accused LAN of abuse of dominance, especially in the route Santiago – Punta Arenas.\(^4\) In their complaint, the Congressmen accused LAN of decreasing rates and increasing flight frequencies, which in their view was an exclusionary practice considering its dominant position, the favorable treatment of LAN in the national airports and the high entry barriers in the market. In conclusion, the Congressmen requested the FNE, amongst other issues, to review whether LAN was complying with the Self-Regulation Plan and to investigate whether the company was applying predatory pricing to exclude its competitor -Sky Airline- of the Santiago-Punta Arenas route.

16. After careful review, the FNE closed the investigation and rejected all allegations, arguing that the agency receives and processes data regarding competitive and noncompetitive routes on a monthly basis, and has not observed any abnormalities or diversion from the average tendencies in the particular route of Santiago - Punta Arenas.

17. Regarding the predatory pricing accusation, the FNE determined that there was no evidence that would justify the existence of such behavior, based on the cost test analysis developed during the investigation. In addition, the FNE argued that the mechanism for allocating slots and other airport facilities, in both the Santiago and Punta Arenas airports, does not constitute an entry barrier.

2. International Services

18. Chile has followed an open skies policy in commercial aviation that is based on free market entry, free market pricing and minimal intervention by the aviation authority. For the application of these general guidelines to foreign companies, Chile has requested reciprocal rights from their countries of origin. As a result, international routes have been opened up on varying degrees, depending on the freedom of air that other countries have been implementing.

19. International passenger and freight transport is less concentrated than their equivalent national markets, though LAN is still dominant in the market, holding around 65%\(^5\) of passenger service and 56%\(^6\) of freight services. On some routes there are important competitors; nevertheless, several airlines have stopped offering direct services to Chile, such as Lufthansa and Swiss Air.

20. The FNE has initiated few cartel investigations against airlines, and to date has never proceeded to file a complaint before the Competition Tribunal. Nonetheless, in 2009, LAN Cargo, the subsidiary of LAN Airlines for freight services, pleaded guilty and was convicted by the Department of Justice of the United States of America, for participating in an international conspiracy to fix prices in the air cargo industry. The Chilean market was one of the affected markets; because of this, the FNE considered bringing charges before the Competition Tribunal, after a complaint filed by the Chamber of

\[^3\] Nonetheless, in 2004 the Competition Commission resolved against LAN Chile and LAN Express for lack of compliance with earlier resolution of the Commission on the Self-Regulation Plan (Res. 723-2004).

\[^4\] FNE Rol N° 2118-12, Congressmen filed a complaint against LAN for conducts that are considered an infringement to competition.

\[^5\] Source JAC. For passenger services the market share includes data for: LAN Airlines, TAM Lineas Aéreas, as well as the subsidiaries of LAN in Peru, Colombia, Ecuador and Argentina.

\[^6\] Source JAC. Freight services Includes data for LAN Airlines and LAN Cargo.
Representatives\textsuperscript{7}. The public information obtained made reference to a price fixing agreement that ended in 2006, therefore exceeding the statute of limitations for competition infringements of the time. As a result, the FNE was forced to close the investigation, and no further actions were taken.

21. In the same year, the FNE received a complaint claiming the existence of an illicit agreement between LAN and Taca, affecting the Santiago-Lima route. The FNE initiated an investigation, but later dismissed the complaint, claiming that there was no evidence of such agreement beyond the observation of a similarity in price which, nonetheless, did not exceed the prices charged in other routes of similar distances.

22. In 2010, the FNE carried out an analysis of code sharing in airline operations and its effects on competition\textsuperscript{8}. In this case, the analysis was limited to passenger air transport, and the relevant markets were defined as city pair combinations. Given the market definition above, as well as market concentration, the FNE highlighted potential risks on the code sharing of LAN with American Airlines, Iberia, Aeromexico and TAM, for the routes Santiago-Miami, Santiago-Madrid, Santiago-Mexico City and Santiago-Sao Paulo, respectively.

23. The FNE identified a series of positive effects of code sharing, such as better coordination of connections and increased network economies, but also highlighted coordination concerns that could potentially lead to increased prices or limitation of flight frequencies. Nonetheless, due to lack of information and data limitations, it was not possible to detect whether such risks had been materialized and even less so whether they had been compensated by potential efficiencies.

24. Code-sharing came to the attention of the FNE once again after the merger of LAN Airlines and Brazilian TAM Linhas Aéreas (hereafter TAM). A more detailed account of the merger will be included in later paragraphs.

25. Air passenger and freight transport are the principal services provided by airlines, however, competition in the sector is directly or indirectly affected by a range of secondary markets. As a result, the FNE has investigated a range of secondary services, including ticket selling, open air policy, and airport infrastructure. In what follows, we will briefly summarize the cases investigated by the FNE as well as the case law issued by the Competition Tribunal.

2.1 LAN – TAM Merger (Resolution N° 37, Competition Tribunal. September 21, 2011):

26. On January 27, 2011, the “Chilean National Corporation of Consumers” (Corporación Nacional de Consumidores y Usuarios de Chile, CONADECUS) filed an inquiry before the Competition Tribunal (the judicial decision making body that replaced the former Commissions), regarding the merger between LAN Airlines S.A. (LAN), the main Chilean airline, and TAM Linhas Aéreas (TAM), one of the largest Brazilian airlines.

27. LAN is the largest airline in Chile, having a market share in national flights -measured in passengers-kilometer, between January and July 2011- of 78.2\%, and of 51\% in international flights to and from Chile. TAM presented a lower market share of national flights in Brazil (44.4\%), but was almost the only Brazilian airline that offered international flights to Chile, with a market share of 89.6\%.

28. In assessing this merger, the Competition Tribunal studied (i) competition between airline carriers in South America as a whole, taking into consideration the fact that this is a network industry, (ii)

\textsuperscript{7} FNE Rol N° 1456-09: Agreement N° 749-0 of the Chamber of Representatives.

\textsuperscript{8} FNE Rol N° 856-07: Investigation on code sharing among Airlines.
passenger routes in which both LAN and TAM competed directly (Santiago – São Paulo and Santiago – Rio de Janeiro), (iii) passenger routes in which only one of the companies participated, but the other one can act as a potential entrant (Santiago – Asunción, Santiago – Buenos Aires, Santiago – Lima, Santiago – Montevideo, São Paulo – Buenos Aires, São Paulo – Montevideo and Rio de Janeiro – Buenos Aires), and (iv) the market for international air cargo transportation.

29. In 21 September 2011, in a divided decision, the Competition Tribunal approved the merger between LAN and TAM. The majority decision (judges Mrs. Butelmann, Mr. Depolo, and Mr. Peña) included a series of mitigation measures, in order to make sure the level of competition after the proposed merger would not be less than the one observed before it: (i) exchange of four of LAN or TAM’s daily slot pairs in São Paulo Guarulhos Airport, with airlines interested in starting or increasing regular air transportation services in the Santiago – São Paulo route; (ii) extension of LATAM’s Frequent Passenger Program benefits to passengers of an interested airline, for 5 years and in the terms indicated by the Tribunal; (iii) subscription of interline agreements in the Santiago – São Paulo, Santiago – Rio de Janeiro and/or Santiago – Asunción routes, with interested airlines offering services in those routes; (iv) prohibition to increase the monthly supply of available seats in the Santiago – São Paulo route between 15 minutes before and 15 minutes after the flight itinerary of the exchanged slots; (v) modification of LAN’s Self-Regulation Plan -which places a cap on rates in national routes where LAN is the only supplier-; (vi) relinquishment of membership of at least one of the two global alliances to which LAN and TAM belong; (vii) elimination and revision of code sharing agreements with airlines that do not belong to the same global alliance as LATAM (the merged company), in the indicated routes and intermediate routes; (viii) resignation by LAN of at least four 5th freedom right frequencies to Lima, in order for them to be reassigned to another Chilean airline, and restriction to LATAM’s participation in future frequency tenders; (ix) commitment by LAN to state its favorable opinion to a unilateral open skies policy for cabotage in Chile by foreign airlines, without reciprocity; (x) commitment to promote growth and the normal operation of the airports of Guarulhos (São Paulo) and Arturo Merino Benítez (Santiago), in order to ease access to other airlines; (xi) establishment of non-exclusionary commercialization conditions with distributors and travel agencies; LATAM cannot establish incentives or commissions based on its participation on total sales of the agent, or equivalents.

30. As long as LATAM hasn’t fully complied with the aforementioned condition (i), air fares for passenger and cargo transport in the routes Santiago – São Paulo and Santiago – Rio de Janeiro cannot be increased, and LATAM must maintain: (a) at least 12 weekly round trip flights in routes connecting Chile with USA, operated directly by LATAM; and (b) at least 7 weekly round trip flights in routes connecting Chile with Europe, operated directly by LATAM. Lastly, LATAM must hire an independent third party consultant, who will assist the National Prosecutor’s Office in the adequate monitoring of LATAM’s compliance to the aforementioned mitigation conditions.

31. Judge Mr. Menchaca concurred to the merger approval but considered that the following conditions should not apply due to their lack of connection to the effects of the Operation or because they were not discussed during the merger review process: (i) resignation of frequencies to Lima; and (ii) prohibition to increase air fares for cargo transport.

32. Judge Mr. Velozo was for rejecting the Operation, considering the following in his dissent vote: (i) concentration of LAN with its closest competitor would consolidate a dominant carrier in Latin America, strengthening LAN’s power in the internal air market, with all the risks this implies for Chilean consumers; (ii) the possibility of timely and viable entry by companies who can challenge LATAM in air transport of passengers between Santiago and Brazil is reduced, and the mitigation conditions are not sufficient to revert that situation; (iii) entry of new airlines who compete with the merged company in most routes to and from Chile is not expected, given LATAM’s position in Santiago airport, and in its hubs in Lima and São Paulo; (iv) current competitors of LAN in Chile will probably connect with LATAM for the
international segments of the trips they offer, which will favor cooperation relations instead of rivalry; (v) the merged company will be able, by itself, to establish new barriers to entry and expansion of competitors, via strategic behavior, and will have significant incentives to do so; (vi) the consolidation of a regional duopoly may increase risks of coordinated conduct that tend to allocate the market, with the implied negative consequences for Chilean consumers: (vii) it is not prudent to authorize a merger of this magnitude as long as there are no substantial advances in the liberalization of this industry in South America, and the merger may be harmful for said deregulation; (viii) the companies that wish to merge did not demonstrate in which way does the merger benefit consumers in the national and international passenger air transport markets, nor have they demonstrated how the efficiencies they intend to reach will not be an obstacle to competition; (ix) the cost savings or productive efficiency gains pursued by LAN with the merger could be reached in ways that impose less risks to competition, such as merging with a South American actor different from TAM, or deepening or broadening its commercial agreements with other airlines in the region; and (x) the substantial increment of LAN’s market power that this operation would cause, would not be effectively controllable by Chilean competition authorities.

2.2 Ticket selling

33. In December 2013, the FNE closed an investigation on the distribution channel of air transport (Rol N° 1889-11). This investigation was initiated after background information collected by the FNE while investigating the LAN – TAM merger. This information indicated that LAN might have used a margin squeeze strategy against rival travel agencies (by paying excessively low commission to travel agencies for ticket selling, or subsidizing its own distribution platform by not charging for the services provided by the platform to consumers), favoring its own online distribution channel, at www.lan.com.

34. In its analysis, the FNE argued that an exclusionary conduct on the downstream market would not have been rational for LATAM, given that the market is highly fragmented, and thus the possibility that other airlines enhance their own distribution platforms reduces the risk that the downstream margin squeeze can cause upstream exclusionary effects. Considering the above, the FNE closed the investigation with no further actions taken.

2.3 Open skies

35. In 2013, Tampa Cargo S.A. (hereafter Tampa) a freight air transport firm, subsidiary of Avianca-Taca, filed a complaint before the FNE against the Civil Aviation Authority, claiming the latter had acted unlawfully when denying a request for authorization to operate regular freight services on a bi-weekly frequency, using third and fourth degree of liberty rights for the route Chile – Colombia and sixth degree of liberty rights for destinations in the United States. Tampa claimed that the Chilean Civil Aviation Authority acted against competition law and denied entry in a route that was highly concentrated.

36. The main argument used by the Chilean Civil Aviation Authority when rejecting the request was the reciprocity principle in effect between Chile and Colombia. The Chilean Authority claimed that the Colombian airline requested for rights that were not provided to Chilean airlines in Colombia. Indeed, the arguments included in the complaint were all strictly related to the interpretation of sector regulations.

---

9 Third and fourth degree liberty rights consist of the right to transport between Chile and the country of origin of the airline requesting the rights.

10 Sixth degree liberty rights consist of the right to transport between Chile and a third country, using the country of origin of the airline requesting the line, as a stopover.
37. After assessing the case, the FNE determined that, considering the degree of air liberty between Chile and Colombia at the time, the Civil Aviation Authority was acting within its right to deny Tampa the operation of the requested services. Furthermore, it was possible to confirm that a similar request had also been rejected in Colombia. Nonetheless, the FNE made a general recommendation to JAC to consider the effects of requests such as this in competition in the freight transport, and suggested to not always request reciprocity when foreign airlines ask for the right to operate in national routes.