

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**FORM 20-F**

☐ **REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g) OF THE SECURITIES EXCHANGE ACT OF 1934**

OR

☒ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2005

OR

☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

OR

☐ **SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

for the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 1-14728

**Lan Airlines S.A.**  
(Exact name of registrant as specified in its charter)

**Lan Airlines S.A.**  
(Translation of registrant's name into English)

**Republic of Chile**  
(Jurisdiction of incorporation or organization)

**Presidente Riesco 5711 Piso 20  
Las Condes,  
Santiago, Chile**  
(Address of principal executive offices)

Securities registered or to be registered pursuant to Section 12(b) of the Act:

Title of each class:	Name of each exchange on which registered:
American Depositary Shares (as evidenced by American Depositary Receipts), each representing five shares of Common Stock, without par value	New York Stock Exchange

Securities registered or to be registered pursuant to Section 12(g) of the Act:

**None**

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act:

**None**

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report: 318,909,090

Indicate by check mark if the registrant is a well-known seasoned issuer, as defines in Rule 405 of the Securities Act.

Yes ☒ No ☐

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

Yes ☐ No ☒

Note – Checking the box above will not relieve any registrant required to file reports pursuant to Section 13 or 5(d) of the Securities Exchange Act of 1934 from their obligations under those Sections.

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes ☒ No ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated filer ☒

Accelerated filer ☐

Non-Accelerated filer ☐

Indicate by check mark which financial statement item the registrant has elected to follow:

Item 17 ☐ Item 18 ☒

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes ☐ No ☒

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## PRESENTATION OF INFORMATION

In this annual report on Form 20-F, unless the context otherwise requires, references to “Lan Airlines” are to Lan Airlines S.A., the unconsolidated operating entity, and references to “LAN,” “we,” “us” or the “Company” are to Lan Airlines S.A. and its consolidated subsidiaries. All references to “Chile” are references to the Republic of Chile.

This annual report contains conversions of certain Chilean peso amounts into U.S. dollars at specified rates solely for the convenience of the reader. These conversions should not be construed as representations that the Chilean peso amounts actually represent such U.S. dollar amounts or could be converted into U.S. dollars at the rate indicated. Unless we specify otherwise, all references to “\$”, “US\$”, “U.S. dollars” or “dollars” are to United States dollars, references to “pesos”, “Chilean pesos” or “Ch\$” are to Chilean pesos and references to “UF” are to *Unidades de Fomento*, a daily indexed Chilean peso-denominated monetary unit that takes into account the effect of the Chilean inflation rate. Unless we indicate otherwise, the U.S. dollar equivalent for information in Chilean pesos is based on the observed exchange rate published by *Banco Central de Chile* (which we refer to as the Central Bank of Chile) on December 30, 2005, which was Ch\$514.21=US\$1.00. The observed exchange rate on June 15, 2006 was Ch\$544.51=US\$1.00. The Federal Reserve Bank of New York does not report a noon buying rate for Chilean pesos. See “Key Information—Exchange Rates” under Item 3.

Lan Airlines and the majority of our subsidiaries (including our main cargo subsidiary LAN Cargo S.A., which we refer to as “LAN Cargo”) maintain their accounting records and prepare their financial statements in U.S. dollars. Some of our other subsidiaries, however, maintain their accounting records and prepare their financial statements in Chilean pesos. Our consolidated financial statements include the results of these subsidiaries translated into U.S. dollars. Current generally accepted accounting principles in Chile, or Chilean GAAP, require monetary assets and liabilities to be translated at period-end exchange rates, non-monetary assets and liabilities to be translated at historical rates of exchange as of the date of acquisition or incurrence and revenue and expense accounts to be translated at the average monthly exchange rate for the month in which they are recognized. As required by Chilean GAAP, the financial statements of our subsidiaries that report in Chilean pesos are adjusted to reflect changes in the purchasing power of the Chilean peso due to inflation. These changes are based on the consumer price index published by the Chilean National Institute of Statistics.

Our consolidated financial statements are prepared in accordance with Chilean GAAP, which differs in certain significant respects from generally accepted accounting principles in the United States, or U.S. GAAP. For a description of certain significant differences between Chilean GAAP and U.S. GAAP as they relate to us, together with a reconciliation of our net income and shareholders’ equity to U.S. GAAP, see Note 26 to our audited consolidated financial statements.

We have rounded percentages and certain U.S. dollar and Chilean peso amounts contained in this annual report for ease of presentation. Any discrepancies in any table between totals and the sums of the amounts listed are due to rounding.

This annual report contains certain terms that may be unfamiliar to some readers. You can find a glossary of these terms on page 4 of this annual report.

## FORWARD LOOKING STATEMENTS

This annual report contains forward-looking statements. Such statements may include words such as “anticipate,” “estimate,” “expect,” “project,” “intend,” “plan,” “believe” or other similar expressions. Forward-looking statements are statements that are not historical facts, including statements about our beliefs and expectations. These statements are based on current plans, estimates and projections, and, therefore, you should not place undue reliance on them. Forward-looking statements involve inherent risks and uncertainties. We caution you that a number of important factors could cause actual results to differ materially from those contained in any forward-looking statement. These factors include, but are not limited to:

- our ability to service our debt and fund our working capital requirements;

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- future demand for passenger and cargo air service in Chile, other countries in Latin America and the rest of the world;
- the maintenance of relationships with customers;
- the state of the Chilean and world economies and airline industries;
- the effects on us from competition;
- future terrorist incidents or related activities affecting the airline industry;
- the relative value of the Chilean peso compared to other currencies;
- inflation;
- increases in interest rates; and
- changes in the regulatory environment in which we operate.

Forward-looking statements speak only as of the date they are made, and we undertake no obligation to update publicly any of them, whether in light of new information, future events or otherwise. **You should also read carefully the risk factors described in “Key Information—Risk Factors” under Item 3.**

## GLOSSARY OF TERMS

The following terms, as used in this annual report, have the meanings set forth below.

### Capacity Measurements:

“available seat kilometers” or “ASKs”	The number of seats made available for sale multiplied by the kilometers flown.
“available ton kilometers” or “ATKs”	The number of tons of capacity available for the transportation of revenue load (passengers and/or cargo) multiplied by the kilometers flown.
“systems available ton kilometers” or “systems ATKs”	The number of total tons capacity for the transportation of revenue load (passenger and cargo) multiplied by the kilometers flown.

### Traffic Measurements:

“cargo ton kilometers”	The cargo load in tons multiplied by the kilometers flown.
“revenue passenger kilometers” or “RPKs”	The number of revenue passengers carried multiplied by the kilometers flown.
“revenue ton kilometers” or “RTKs”	The load (passenger and/or cargo) in tons multiplied by the kilometers flown.
“traffic revenue”	Revenue from passenger operations plus revenue from cargo operations.

### Yield Measurements:

“cargo yield”	Revenue from cargo operations divided by RTKs.
“overall yield”	Revenue from airline operations (passenger and cargo) divided by RTKs (passenger and cargo).
“passenger yield”	Revenue from passenger operations divided by either RPKs or RTKs.

### Load Factors:

“cargo load factor”	RTKs (cargo) expressed as a percentage of ATKs (cargo).
“overall break-even load factor”	Total costs (operating expenses plus net interest expense less other revenue) per ATK (passenger and cargo) divided by overall yield.
“overall load factor”	RTKs (passenger and cargo) expressed as a percentage of ATKs (passenger and cargo).
“passenger break-even load factor”	Total costs attributable to passenger operations per ASK divided by passenger yield.
“passenger load factor”	RPKs expressed as a percentage of ASKs.

**Other:**

“ACMI Contract”	A type of aircraft leasing contract, under which the lessor provides the aircraft, crew, maintenance and insurance on a per hour basis. Also referred to as a “wet lease”.
“on time rate”	Percentage of flights that depart within fifteen minutes of scheduled take-off time.
“ton”	A metric ton, equivalent to 2,204.6 pounds.
“utilization rates”	The actual number of flight hours per aircraft per operating day.

## PART I

### ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS

Not applicable.

### ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE

Not applicable.

### ITEM 3. KEY INFORMATION

#### Selected Financial Data

The following table presents our summary financial and other information for each of the last five fiscal years in the period ended December 31, 2005. The summary financial information for the three fiscal years in the period ended December 31, 2005 has been derived from our audited consolidated financial statements included in this report.

You should read the information below in conjunction with our audited consolidated financial statements and the notes thereto, as well as “Presentation of Information” and “Operating and Financial Review and Prospects”.

#### Annual Financial Information

	Year ended December 31,				
	2001	2002	2003	2004	2005
(in US\$ millions, except per share and capital stock data)					
<b>The Company<sup>(1) (5)</sup></b>					
<b>Statement of Income Data:</b>					
<i>Chilean GAAP</i>					
Operating revenues					
Passenger	\$ 803.0	\$ 803.7	\$ 918.4	\$ 1,169.0	\$ 1,460.6
Cargo	539.5	520.8	602.0	799.7	910.5
Other	85.8	127.9	118.4	124.2	135.3
Total operating revenues	1,428.3	1,452.4	1,638.8	2,092.9	2,506.4
Operating expenses <sup>(2)</sup>	1,378.1	1,390.4	1,527.1	1,920.8	2,364.7
Operating income	50.3	62.1	111.7	172.1	141.6
Other income (expense)					
Interest income	5.5	3.8	6.3	10.8	12.4
Interest expense	(35.5)	(40.8)	(39.4)	(36.5)	(39.2)
Miscellaneous-net <sup>(2)</sup>	(8.4)	13.2	24.1	45.2	58.2
Total other income (expense)	(38.4)	(23.8)	(9.0)	19.5	31.5
Minority interest	(1.6)	(0.4)	(0.9)	0.2	1.8
Income before income taxes	10.3	37.8	101.9	191.8	174.9
Income taxes	0.6	(7.0)	(18.3)	(28.3)	(28.3)
Net income	\$ 10.8	\$ 30.8	\$ 83.6	\$ 163.6	\$ 146.6
Net income per common share <sup>(3)</sup>	\$ 0.03	\$ 0.10	\$ 0.26	\$ 0.51	\$ 0.46
Net income per ADS <sup>(3)</sup>	\$ 0.17	\$ 0.48	\$ 1.31	\$ 2.56	\$ 2.30
<i>Statistics</i>					
ASKs (million)	16,901.7	17,066.8	18,323.9	21,147.4	23,687.3
RPKs (million)	11,279.8	11,139.5	12,671.0	15,125.3	17,490.8
ATKs (million)	2,676.4	2,731.0	2,848.7	3,288.4	3,599.7
RTKs (million)	1,853.2	1,833.8	1,911.9	2,259.4	2,392.3
System ATKs (million)	4,237.1	4,281.8	4,539.2	5,256.2	5,810.8
<i>U.S. GAAP</i>					
Operating revenues	\$ 1,441.3	\$ 1,452.4	\$ 1,638.8	\$ 2,092.9	\$ 2,506.4
Operating income	25.6	56.6	125.0	218.5	195.4
Net income	1.0	34.2	88.8	160.7	155.0
Basic and diluted earnings per share <sup>(3)</sup>	0.00	0.11	0.28	0.50	0.49
Net income per ADS <sup>(3)</sup>	\$ 0.02	\$ 0.54	\$ 1.39	\$ 2.52	\$ 2.43



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	At December 31,				
	2001	2002	2003	2004	2005
	(in US\$ millions, except per share and capital stock data)				
<b>Balance Sheet Data:</b>					
<i>Chilean GAAP</i>					
Cash, time deposits and marketable securities	\$ 73.4	\$ 159.4	\$ 219.0	\$ 304.6	\$ 159.2
Miscellaneous current assets <sup>(4)</sup>	261.1	256.4	267.7	347.8	420.0
Property and equipment	985.8	1,026.4	1,009.5	979.0	1,252.3
Total other assets	114.7	143.2	132.3	197.9	314.3
Total assets	1,435.5	1,585.4	1,628.5	1,829.3	2,145.8
Long-term liabilities	722.2	813.5	765.4	809.0	955.3
Shareholders' equity	288.5	308.9	352.6	434.6	502.7
<i>U.S. GAAP</i>					
Total assets	\$1,422.4	\$1,545.4	\$1,610.5	\$1,829.2	\$2,145.8
Long-term liabilities	740.8	821.6	777.0	809.0	955.2
Shareholders' equity	237.3	258.9	323.5	434.6	502.7
Capital stock (millions of shares)	318.9	318.9	318.9	318.9	318.9

- (1) For more information on the subsidiaries included in this consolidated account, see Note 2(b) to our audited consolidated financial statements.
- (2) To reflect operational results more clearly, fuel hedging gains or losses have been reclassified as a non-operational item in the Miscellaneous-net line in each of 2001, 2002, 2003, 2004 and 2005. We recorded US\$10.5 million fuel hedge loss in 2001, a US\$5.5 million fuel hedge loss in 2002, a US\$12.3 million fuel hedge gain in 2003, a US\$46.5 million fuel hedge gain in 2004, and a US\$51.5 million fuel hedge gain in 2005.
- (3) We had 318,909,090 common shares outstanding in each of the periods indicated, which is equivalent to 63,781,818 ADSs.
- (4) Total current assets less the sum of cash, time deposits and marketable securities.
- (5) The sums of the items may differ from the total amount due to rounding.

Although most of our revenues and expenses are denominated in U.S. dollars, some of our expenses and cost are denominated in different currencies such as the Chilean peso. Fluctuations in foreign exchange rates could lead to changes in their value in U.S. dollars. However, the impact on our results of this change is significantly mitigated by the partial natural hedge arising from approximately 80% of our revenues and 73% of operating expenses being denominated in U.S. dollars.

In accordance with the Chilean Corporation Law, we must pay annual cash dividends equal to at least 30% of its annual consolidated distributable net income each year (calculated in accordance with Chilean GAAP), subject to limited exceptions. As of May 31, 2006, we had declared aggregate dividends of US\$1.4 million with respect to income for 2001, US\$13.8 million with respect to income for 2002, US\$41.8 million, with respect to income for 2003, US\$81.8 million, with respect to income for 2004 and US\$73.3 million with respect to income for 2005. The total dividend for 2005 was divided into two interim dividends paid on September 2005 and March 2006 and a final dividend paid on May 17, 2006. The table below sets forth the

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cash dividends per common share, as well as the number of common shares entitled to such dividends, for the years indicated. Dividend per common share amounts have not been adjusted for inflation and reflect common share amounts outstanding immediately prior to the distribution of such dividend.

Dividend for year:	Payment date(s)	Total dividend payment (U.S. dollars)	Number of common shares entitled to dividend (in millions)	Cash dividend per common share (U.S. dollars)
2001	May 10, 2002	1,406,760	318.91	0.00441
2002	January 15, 2003	8,958,156	318.91	0.02809
	May 9, 2003	4,854,607	318.91	0.01521
2003	August 19, 2003	11,583,448	318.91	0.03632
	November 21, 2003	23,415,900	318.91	0.07343
	May 13, 2004	6,776,018	318.91	0.02124
2004	August 24, 2004	39,785,909	318.91	0.12475
	December 29, 2004	34,997,084	318.91	0.10974
	May 13, 2005	6,992,865	318.91	0.02193
2005	September 2, 2005	36,451,309	318.91	0.11430
	March 1, 2006	35,000,000	318.91	0.10975
	May 17, 2006	1,849,186	318.91	0.00580

Our board of directors has the authority to declare interim dividends. Year-end dividends, if any, are declared by our shareholders at our annual meeting. For a description of our dividend policy, see “—Other Financial Information—Dividend Policy” under Item 8.

We declare cash dividends in U.S. dollars, but make dividend payments in Chilean pesos, converted from U.S. dollars at the observed exchange rate two days prior to the day we first make payment to shareholders. Payments of cash dividends to holders of American Depositary Receipts, or ADRs, if any, are made in Chilean pesos to the custodian, which converts those Chilean pesos into U.S. dollars and delivers U.S. dollars to the depositary for distribution to holders. In the event that the custodian is unable to convert immediately the Chilean currency received as dividends into U.S. dollars, the amount of U.S. dollars payable to holders of ADRs may be adversely affected by devaluations of the Chilean currency that occur before such dividends are converted and remitted.

### Exchange Rates

The following table sets forth, for the yearly periods indicated, the high, low, average and period-end observed exchange rate for the purchase of U.S. dollars, expressed in Chilean pesos per U.S. dollar. The rates have not been restated in constant currency units.

Year Ended December 31,	Daily Observed Exchange Rate			
	High	Low	Average <sup>(1)</sup>	Period-end
	Ch\$ per US\$			
2001	716.62	557.13	636.39	656.20
2002	756.56	641.75	694.46	712.38
2003	758.21	593.10	687.51	599.42
2004	649.45	559.21	612.13	559.83
2005	592.75	509.70	559.27	514.21

Source: Central Bank of Chile

<sup>(1)</sup> Average of the month-end exchange rates for the relevant period.

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The following table sets forth, for the monthly periods indicated, the high and low exchange rate for the purchase of U.S. dollars, expressed in Chilean pesos per U.S. dollar.

	Daily Observed Exchange Rate Ch\$ per US\$		
	Low	High	Period-End
<b>Month in 2005</b>			
December	509.70	518.63	514.21
<b>Month in 2006</b>			
January	512.50	535.36	524.78
February	516.91	532.35	517.76
March	516.75	536.16	527.70
April	511.44	526.18	518.62
May	512.76	532.92	531.11

Source: Central Bank of Chile

On June 15, 2006 the observed exchange rate was Ch\$544.51 = US\$1.00.

### **Risk Factors**

*We wish to caution readers that the following important factors, and those important factors described in other reports submitted to, or filed with, the Securities and Exchange Commission, among other factors, could affect our actual results and could cause our actual results to differ materially from those expressed in any forward-looking statements made by us or on our behalf. In particular, as we are a non-U.S. company, there are risks associated with investing in our American Depositary Shares, or ADS, that are not typical for investments in the shares of U.S. companies. Prior to making an investment decision, you should carefully consider all of the information contained in this document, including the following risk factors.*

#### **Risks Related to our Operations and the Airline Industry**

*Our performance is heavily dependent on economic conditions in the countries in which we do business.*

Passenger and cargo demand is heavily cyclical and highly dependant on global and local economic growth, economic expectations and foreign exchange rate variations. In the past we have been impacted by weak economic growth in Chile, recession in Argentina and poor economic performance in certain emerging market countries in which we operate. Any of the following factors could adversely affect our business, financial condition and results of operations in the countries in which we operate:

- changes in economic or other governmental policies;
- weak economic performance, including, but no limited to, low economic growth, low consumption and/or investment rates, and increased inflation rates;
- changes in the regulatory, legal or administrative practices; or
- other political or economic developments over which we have no control.

Similar future events occurring in one or more countries in which we operate could have a material effect on our results of operations.

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*Our business may be adversely affected by a downturn in the airline industry caused by exogenous events that affect travel behavior or increase costs, such as outbreak of disease, war or terrorist attacks.*

Demand for air transportation may be adversely impacted by exogenous events, such as natural disasters, epidemics, terrorist attacks, war or political and social instability. Situations such as these in one or more of the markets in which we operate could have a material impact on our business, financial condition and results of operations. Furthermore, this type of situations could have a prolonged effect on air transportation demand and on certain cost items.

For example, the terrorist attacks in the United States on September 11, 2001 had a severe adverse impact on the airline industry, particularly on foreign air carriers operating international service to and from the United States. Throughout South America, passenger traffic also decreased substantially, although the decrease was less severe than that in the United States. The airline industry has experienced increased costs following the September 11, 2001 terrorist attacks. Airlines have been required to adopt additional security measures and may be required to comply with more rigorous security guidelines in the future. Premiums for insurance against aircraft damage and liability to third parties increased substantially and could escalate further.

In addition, fuel prices and supplies, which constitute a significant cost for us, may increase as a result of any future terrorist attacks, a general increase in hostilities or a reduction in output of fuel, voluntary or otherwise, by oil-producing countries. Such increases may result in both higher airline ticket prices and decreased demand for air travel generally, which could have an adverse effect on our revenues and results of operations.

*A significant portion of our cargo revenues comes from relatively few product types and may be impacted by events affecting their production or trade.*

Our cargo demand, especially from Latin American exporters, is concentrated in a small number of product categories, such as salmon and produce exports from Chile and Peru, and fresh flowers from Ecuador and Colombia. Events that negatively affect the production or trade of these goods may adversely affect the volume of goods that we transport and may have a significant impact on our results of operations. Some of our cargo product are sensitive to foreign-exchange rates and, therefore, traffic volumes could be impacted by the appreciation or depreciation of local currencies.

*Our operations are subject to fluctuations in the supply and cost of jet fuel.*

Higher jet fuel prices or a shortage in the supply of fuel could cause a reduction in our scheduled service and could materially affect our business, financial condition and results of operations. Jet fuel costs have historically accounted for a significant amount of our operating expenses, and accounted for 27.2% of our operating expenses in 2005. Both the cost and availability of fuel are subject to many economic and political factors and events that we can neither control nor predict. We have entered into fuel hedging arrangements, but there can be no assurance that such arrangements will be adequate to protect us from a significant increase in fuel prices in the near future or in the long term. Also, while these hedging arrangements are designed to limit the effect of an increase in fuel prices, some of our hedging methods may also limit our ability to take advantage of any decrease in fuel prices. Although we have implemented measures to pass a portion of incremental fuel costs to our customers, our ability to lessen the impact of any increase using this type of mechanisms may also be limited.

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*We rely on maintaining a high daily aircraft utilization rate to increase our revenues, which makes us especially vulnerable to delays.*

One of the key elements of our business strategy is to maintain a high daily aircraft utilization rate, which measures the number of flight hours we use our aircraft per day. High daily aircraft utilization allows us to maximize the amount of revenue we generate from our aircraft and is achieved, in part, by reducing turnaround times at airports and developing schedules that enable us to fly more hours on average per day. Our rate of aircraft utilization could be adversely affected by a number of different factors that are beyond our control, including air traffic and airport congestion, adverse weather conditions and delays by third-party service providers relating to matters such as fueling and ground handling.

Furthermore, high aircraft utilization rates increase the risk that, if an aircraft falls behind schedule, it could remain behind schedule for up to two days. Such delays could result in a disruption in our operating performance, leading to customer dissatisfaction due to any resulting delays or missed connections.

*We are often affected by certain factors beyond our control, including weather conditions, which can affect our operations.*

Generally, revenues for airlines depend on the number of passengers carried, the fare paid by each passenger and service factors, such as the timeliness of flight departures and arrivals. During periods of fog, ice, low temperatures, storms or other adverse weather conditions, some or all of our flights may be cancelled or significantly delayed and, as a result, our revenues could suffer.

*Losses and liabilities in the event of an accident involving one or more of our aircraft could materially affect our business.*

We are exposed to potential catastrophic losses in the event of an aircraft accident, terrorist incident or any other unpredictable event. There can be no assurance that, as a result of an aircraft accident or incident:

- we will not need to increase our insurance coverage;
- our insurance premiums will not increase significantly;
- our insurance coverage will fully cover all of our liability; or
- we will not be forced to bear substantial losses.

Substantial claims resulting from an accident or incident in excess of our related insurance coverage could have a material adverse effect on our business, financial condition and results of operations. Moreover, any aircraft accident, even if fully insured, could cause the negative public perception that our aircraft are less safe or reliable than those operated by other airlines, which could have a material adverse effect on our business, financial condition and results of operations.

Insurance premiums may also increase due to an accident or incident affecting one of our airline affiliates or alliance partners or affecting other airlines.

*Our business may suffer if any of our strategic partners terminate our alliance or commercial relationship.*

We maintain a number of alliances and other commercial relationships with strategic partners that allow us to enhance our network and, in some cases, offer our customers services that we could not otherwise offer. If our relationship with any of our strategic partners and, in particular, with American Airlines, Iberia, Qantas or **oneworld**<sup>®</sup> deteriorates, or any of these agreements are terminated, our business, financial condition and results of operations could be negatively affected.

*High levels of competition in the airline industry may adversely affect our level of operations.*

Our business, financial condition and results of operations could be adversely affected by high levels of competition within the industry, particularly the entrance of new competitors into the markets in which we operate. Airlines compete primarily over fare levels, frequency and dependability of service, brand

recognition, passenger amenities (such as frequent flyer programs) and the availability and convenience of other passenger or cargo services. New and existing airlines could enter our markets and compete with us on any of these bases. Several of our competitors are larger than us and have greater brand recognition and greater resources than we do. Competing carriers include investor-owned, government-subsidized and national flag carriers of foreign countries. The U.S.-Chile and other open skies agreements may subject us to further competition from international carriers. In addition to traditional competition among airline companies, we face competition from companies that provide ground transportation, especially in our cargo and domestic passenger businesses, as well as sea transportation for our cargo business. Competition could reduce our passenger traffic, forcing us to reduce our fare levels, which could have a material adverse effect on our revenues and level of operations.

*Our plans for regional expansion within Latin America depend upon key regulatory and commercial issues.*

We plan to continue to increase the scale of our operations and revenues by expanding our presence outside of Chile, both directly and through our affiliates. Our ability to successfully implement this strategy will depend upon many factors, several of which are outside our control or subject to change. These factors include the permanence of a suitable political, economic and regulatory environment in the Latin American countries in which we operate or intend to operate and our ability to identify and maintain strategic local partners. Additionally, fare controls may limit our ability to effectively apply revenue management techniques and adjust prices to reflect cost pressures. Also, high levels of government regulation may limit the scope of our operations and our growth plans, especially in the event of deterioration of the relations between the countries in which we operate or the public perception of foreign companies in local markets. These restrictions could materially affect our business, financial condition, result of operations and future expansion plans.

*Some of our competitors may receive external support which could negatively impact our competitive position*

Some of our competitors may receive support from external sources, such as their national governments, which may be unavailable to us. Support may include, among others, subsidies, financial aid or tax waivers. This support could place us at a competitive disadvantage and adversely affect our operations and financial performance.

*If we are unable to incorporate leased aircraft into our fleet at acceptable rates and terms in the future, our business could be adversely affected.*

The majority of our aircraft are subject to long-term operating leases. Our operating leases typically run from three to 12 years from the date of delivery. We may face more competition for, or a limited supply of, leased aircraft, making it difficult for us to negotiate terms similar to those we now have upon expiration of our current operating leases or to lease additional capacity required for our targeted level of operations. If we are forced to pay higher lease rates in the future to maintain our capacity and the number of aircraft in our fleet, our profitability could be adversely affected.

*We fly and depend upon Airbus and Boeing aircraft, and our business is at risk if we do not receive timely deliveries of aircraft or if the public negatively perceives our aircraft.*

As of May 31, 2006, we operated a fleet of 26 Airbus and 50 Boeing aircraft. As our fleet grows, our risk in relying on these two manufacturers also grows. These risks include:

- the failure or inability of Airbus or Boeing to provide sufficient aircraft, parts or related support services on a timely basis;
- the interruption of fleet service as a result of unscheduled or unanticipated maintenance requirements for these aircraft;
- the issuance of FAA or other directives restricting or prohibiting the use of Airbus or Boeing aircraft or requiring time-consuming inspections and maintenance; or

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- the adverse public perception of a manufacturer as a result of an accident or other negative publicity.

The occurrence of any one or more of these factors could restrict or end our ability to use the affected property to generate profits or could otherwise limit our operations.

*We are incorporating various new technologies and equipment and their phase-in may have a negative impact on our service and operating standards*

In recent years we have decided to incorporate a number of new aircraft, equipment and systems. The decision to incorporate these new elements has been based on their potential to enhance customer satisfaction, increase efficiency and/or streamline processes. However, the phase-in of these elements may temporarily result in lower service and operating standards which could affect how our customers perceive us.

*Our business may be adversely affected if we are unable to meet our significant future financing requirements.*

We require significant amounts of financing to meet our aircraft capital requirements, and may require additional financing to fund our other business needs. We cannot guarantee that we will have access to or be able to arrange for financing in the future on favorable terms. If we are unable to obtain financing for a significant portion of our capital requirements, our ability to acquire new aircraft or to expand operations could be impaired.

*Our business may be adversely affected by our high degree of debt and aircraft lease obligations compared to our equity capital.*

We have a high degree of debt and payment obligations under our aircraft operating leases compared to equity capital. In order to finance our debt, we depend in part on our cash flow from operations. We cannot assure that in the future we will be able to fully finance our business operations and expansion efforts. In addition, the majority of our property and equipment is subject to liens securing our indebtedness. In the event that we fail to make payments on the secured indebtedness, creditors' enforcement of liens could limit or end our ability to use the affected property and equipment to generate revenue.

*Future changes in the status of Chilean and foreign governmental authorizations and licenses could adversely affect our business.*

Our business, financial condition and results of operations could be adversely affected if we or certain aviation authorities (among them, those from Argentina, Brazil, Chile, Ecuador, Mexico, Peru and the United States) fail to maintain the required foreign and domestic governmental authorizations. In order to maintain the necessary authorizations issued by the Chilean *Junta Aeronáutica Civil*, which we refer to as the JAC, and technical operative authorizations issued by the Chilean *Dirección General de Aeronáutica Civil*, which we refer to as the DGAC, and other corresponding local authorities, we must continue to comply with applicable statutes, rules and regulations pertaining to the airline industry, including any rules and regulations that may be adopted in the future.

We are subject to various international bilateral air transport agreements that provide for, among other things, the exchange of air traffic rights between the countries in which our companies are based and other countries to which we provide service. We must also obtain permission from the applicable foreign governments to provide service to foreign destinations. There can be no assurance that existing bilateral agreements between the countries in which our companies are based and foreign governments will continue. A modification, suspension or revocation of one or more bilateral agreements could have a material adverse effect on our business, financial condition and results of operations. The suspension of our permission to operate to certain airports or destinations or the imposition of other sanctions could also have a material adverse effect. We cannot assure that a change in a foreign government's administration of current laws and regulations or that the adoption of new laws and regulations will not have a material adverse effect on our business, financial condition and results of operations.

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We are also subject to antitrust regulation by the Chilean government because of our dominant position in the Chilean domestic passenger market. There are no legal barriers to entry in the Chilean airline industry, however, and we could face additional competition in the future on any or all of our domestic routes, including competition from foreign air carriers that establish a corporate presence in Chile.

*Our ability to service certain important destinations could be limited in the future.*

If we are unable to obtain favorable take-off and landing authorizations at certain high-density airports, our business, financial condition and results of operations could be adversely affected. Some airports in the United States are subject to take-off and landing restrictions administered by the U.S. Federal Aviation Administration, which is also known as the FAA. There can be no assurance that we will be able to obtain all requested authorizations and slots in the future because, among other factors, government policies regulating the distribution of the authorizations and slots are subject to change.

*Problems with air traffic control systems or other technical failures could interrupt our operations and materially affect our business.*

Our operations, including our ability to deliver customer service, are dependent on the effective operation of our equipment, including our aircraft, maintenance systems and reservation systems. Our operations are also dependent on the effective operation of domestic and international air traffic control systems and the air traffic control infrastructure in the markets in which we operate. Equipment failures, personnel shortages, air traffic control problems and other factors that could interrupt operations could adversely affect our operations and financial results and our reputation.

*Our financial success depends on the availability and performance of key personnel.*

Our success depends to a significant extent on the ability of our senior management team and key personnel to operate and manage our business effectively. Our employment agreements with key personnel do not contain any non-competition provisions. Competition for highly qualified personnel is intense. If we lose any executive officer, senior manager or other key employee and are not able to obtain an adequate replacement, or if we are unable to attract and retain new qualified personnel, our business, financial condition and results of operations could be materially adversely affected.

*Our business may experience adverse consequences if we are unable to reach satisfactory collective bargaining agreements with our unionized employees.*

A substantial number of our administrators, cabin crews, flight attendants, pilots and maintenance technicians are members of unions and have contracts and collective bargaining agreements which expire on a regular basis. Our business, financial condition and results of operations could be materially adversely affected by a failure to reach agreement with any labor union representing such employees or by an agreement with a labor union that contains terms that are not in line with our expectations or that prevent us from competing effectively with other airlines.

*Pressure by employees could cause operating disruptions and negatively impact our business*

Certain employee groups such as pilots, flight attendants, mechanics our airport personnel have highly specialized skills. As a consequence, actions by these groups, such as strikes, walk-outs or stoppages, could severely disrupt our operations and negatively impact our operating and financial performance, as well as how our customers perceive us.

As an example, during the third quarter of 2001, members of one of our pilot unions implemented a series of actions that disrupted our services prior to the negotiation of their collective bargaining agreement, which had a negative impact on our operations and our profitability.



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*Increases in our labor costs, which constitute a substantial portion of our total operating costs, would directly impact our earnings.*

Labor costs constitute a significant percentage of our total operating costs, and at times in our operating history we have experienced pressure to increase wages and benefits for our employees. As a result, a significant increase in our labor costs above the assumed costs could result in a material reduction in our earnings.

*We may experience difficulty finding, training and retaining employees.*

Our business is labor-intensive. We employ a large number of pilots, flight attendants, maintenance technicians and other operating and administrative personnel. The airline industry has, from time to time, experienced a shortage of qualified personnel, specifically pilots and maintenance technicians. In addition, as is common with most of our competitors, we may, from time to time, face considerable turnover of our employees. Should the turnover of employees, particularly pilots and maintenance technicians, sharply increase, our training costs will be significantly higher. We cannot assure you that we will be able to recruit, train and retain the qualified employees that we need to continue our current operations or replace departing employees. A failure to hire and retain qualified employees at a reasonable cost could materially adversely affect our business, financial condition and results of operations.

*We may not be able to secure the resources necessary to sustain our growth.*

Rapid growth may strain our existing management resources and operational, financial and management information systems and controls. Expansion will also require us to hire additional skilled personnel, purchase more equipment and additional or larger facilities, upgrade our internal audit function and implement more detailed long-term budgeting procedures. If we are unable to hire skilled personnel or secure the required equipment and facilities in an efficient, cost-effective manner, we may not be able to achieve our growth plans and sustain or increase our profitability.

*Failure to comply with applicable environmental regulations could adversely affect our business and reputation.*

Our operations are covered by environmental regulations at local, national and international levels. These regulations cover, among other things, emissions to the atmosphere, disposal of solid waste and aqueous effluents, aircraft noise and other activities incident to our business. Future operations and financial results may vary as a result of such regulations. Compliance with these regulations and new or existing regulations that may be applicable to us in the future could increase our cost base and adversely affect our operations and financial results. In addition, failure to comply with these regulations could adversely affect us in a variety of ways, including adverse effects on our reputation.

### **Risks Related to Chile and Other Emerging Market Countries**

*Developments in Latin American countries and other emerging market countries may adversely affect the Chilean economy, negatively impact our business and results of operations and cause the market price of our common shares and ADSs to decrease.*

We conduct a significant portion of our operations in emerging market countries, particularly in Latin America. As a result, economic and political developments in these countries, including future economic crises and political instability, could impact the Chilean economy or the market value of our securities and have a material adverse effect on our business, financial condition and results of operations. Although economic conditions in other emerging market countries may differ significantly from economic conditions in Chile, we cannot assure that events in other countries, particularly other emerging market countries, will not adversely affect the market value of, or market for, our common shares or ADSs.

*Fluctuations in the Chilean peso and other foreign currencies relative to the U.S. dollar may adversely affect our revenues and profitability.*

Changes in the exchange rate between the Chilean peso and the U.S. dollar could adversely affect our business, financial condition and results of operations. We operate in numerous countries and face the risk of variation in foreign currency exchange rates against the U.S. dollar or between the currencies of these various countries. A significant part of our indebtedness is denominated in U.S. dollars, while approximately 20% of our revenues and 27% of our operating expenses in 2005 are denominated in currencies other than the U.S. dollar, mainly the Chilean peso. If the value of the peso or of other currencies in which revenues are denominated declines against the U.S. dollar, we will need more pesos or other local currency to repay the same amount of U.S. dollars. The Chilean peso has experienced significant volatility in recent years, including a nominal increase of approximately 15.9% against the U.S. dollar in 2003, a nominal increase of approximately 6.6% against the U.S. dollar in 2004 and a nominal increase of approximately 8.1% against the U.S. dollar in 2005. The exchange rate of the Chilean peso and other currencies against the U.S. dollar may fluctuate significantly in the future. Changes in Chilean and other governmental economic policies affecting foreign exchange rates could also adversely affect our business, financial condition, results of operations and the return to our shareholders on their common shares or ADSs.

*We are not required to disclose as much information to investors as a U.S. issuer is required to disclose.*

The corporate disclosure requirements that apply to us may not be equivalent to the disclosure requirements that apply to a U.S. company and, as a result, you may receive less information about us than you would receive from a comparable U.S. company. We are subject to the reporting requirements of the Securities Exchange Act of 1934, as amended, or the “Exchange Act”. The disclosure required of foreign issuers under the Exchange Act is more limited than the disclosure required of U.S. issuers. Publicly available information about issuers of securities listed on Chilean stock exchanges also provides less detail in certain respects than the information regularly published by listed companies in the United States or in certain other countries. Furthermore, there is a lower level of regulation of the Chilean securities markets and of the activities of investors in such markets as compared with the level of regulation of the securities markets in the United States and in certain other developed countries.

### **Risks Related to our Common Shares and ADSs**

*Our controlling shareholders may have interests that differ from those of our other shareholders.*

As of May 31, 2006 our controlling shareholders, together, beneficially owned 54.0% of our voting common shares. These controlling shareholders are in a position to elect a majority of the members of our board of directors, direct our management and control substantially all matters that are to be decided by a vote of shareholders, including fundamental corporate transactions. In addition, under the terms of the deposit agreement governing the ADSs, if holders of ADSs do not provide The Bank of New York, in its capacity as depositary for the ADSs, with timely instructions on the voting of the common shares underlying their ADRs, the depositary will be deemed to have been instructed to give a person designated by the board of directors the right to vote those common shares.

*Trading of our ADSs and common shares in the securities markets is limited and could experience further illiquidity and price volatility.*

Chilean securities markets are substantially smaller, less liquid and more volatile than major securities markets in the United States. In addition, Chilean securities markets may be materially affected by developments in other emerging markets, particularly other countries in Latin America. Due to our relatively small public float, our common shares are less actively traded than securities of other companies with larger public floats in more developed countries and, consequently, an ADS holder may have a limited ability to sell ADSs or the common shares underlying ADSs (upon withdrawal from the ADR facility) in the amount and at the price and time that it may desire. This limited trading market may also increase the price volatility of the ADSs or the common shares underlying the ADSs.

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*Holders of ADSs may be adversely affected by currency devaluations and foreign exchange fluctuations.*

If the peso exchange rate falls relative to the U.S. dollar, the value of the ADSs and any distributions made thereon from the depositary, could be adversely affected. Cash distributions made in respect of the ADSs are received by the depositary (represented by the custodian bank in Chile) in pesos, converted by the custodian bank into U.S. dollars at the then prevailing exchange rate and distributed by the depositary to the holders of the ADRs evidencing those ADSs. In addition, the depositary will incur foreign currency conversion costs (to be borne by the holders of the ADRs) in connection with the foreign currency conversion and subsequent distribution of dividends or other payments with respect to the ADSs.

*Future changes in Chilean foreign investment controls and withholding taxes could negatively affect non-Chilean residents that invest in our shares.*

Equity investments in Chile by non-Chilean residents are generally subject to various exchange control regulations that govern investment repatriation and earnings thereon. Although not currently in effect, regulations of the Central Bank of Chile have in the past and could again require foreign investors acquiring securities in the secondary market in Chile to maintain a cash reserve or to pay a fee upon conversion of foreign currency to purchase such securities.

We cannot assure that additional Chilean restrictions applicable to the holders of ADRs, the disposition of the common shares underlying ADSs or the repatriation of the proceeds from an acquisition, a disposition or a dividend payment, will not be imposed or required in the future, nor could we make an assessment as to the duration or impact, were any such restrictions to be imposed or required.

*Our ADS holders may not be able to exercise preemptive rights in certain circumstances.*

The Chilean Corporation Act and Regulation thereof, *Ley sobre Sociedades Anónimas No. 18,046* and the *Reglamento de Sociedades Anónimas*, collectively known as the Chilean Corporation Law, provide that preemptive rights shall be granted to all shareholders whenever a company issues new shares for cash, giving such holders the right to purchase a sufficient number of shares to maintain their existing ownership percentage. We will not be able to offer shares to holders of ADSs and shareholders located in the United States pursuant to the preemptive rights granted to shareholders in connection with any future issuance of shares unless a registration statement under the U.S. Securities Act of 1933, as amended, or the Securities Act, is effective with respect to such rights and shares, or an exemption from the registration requirements of the Securities Act is available. At the time of any rights offering, we will evaluate the potential costs and liabilities associated with any such registration statement in light of any indirect benefit to us of enabling U.S. holders of ADRs evidencing ADSs and shareholders located in the United States to exercise preemptive rights, as well as any other factors that may be considered appropriate at that time, and we will then make a decision as to whether we will file a registration statement. We cannot assure that we will decide to file a registration statement or that such rights will be available to ADS holders and shareholders located in the United States.

## **ITEM 4. INFORMATION ON THE COMPANY**

### **BUSINESS**

#### **Overview**

We are one of the leading passenger airlines in Latin America and the main cargo operator in the region. We currently provide domestic and international passenger services in Chile and Peru, domestic passenger services in Argentina, and international passenger services in Ecuador. We carry out our cargo operations through the use of belly space on our passenger flights and dedicated cargo operations using freighter aircraft through our cargo airlines in Chile, Brazil and Mexico.

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As of May 31, 2006, we service 15 destinations in Chile, 11 destinations in Peru, nine destinations in Argentina, two destinations in Ecuador, ten destinations in other Latin American countries and the Caribbean, three destinations in the United States, two destinations in Europe and four destinations in the South Pacific. In addition, as of May 31, 2006, through our various code-share agreements, we offer service to 54 additional international destinations. We provide cargo service to all our passenger destinations and to 15 additional destinations served only by freighter aircraft. We also offer other services, such as ground handling, courier, logistics, and maintenance.

Lan Airlines S.A. is a publicly-held stock corporation (*sociedad anónima abierta*) incorporated under the laws of Chile. Our principal executive offices are located at Presidente Riesco 5711, Comuna de Las Condes, Santiago, Chile and our general telephone number at this location is (56-2) 565-2525.

### **History of the Company**

The Chilean government founded Lan Airlines (formerly Lan Chile S.A.) in 1929. Lan Airlines was a government-owned company from 1929 until its incorporation in 1983. Lan Airlines began international service to Buenos Aires, Argentina in 1946, to the United States in 1958 and to Europe in 1970. In 1989, the Chilean government sold 51% of Lan Airlines' capital stock to Chilean investors and to Scandinavian Airlines System ("SAS"). In 1994, our controlling shareholders together with other major shareholders acquired 98.7% of Lan Airlines' stock, including the remaining stock held by the Chilean government, in a series of transactions. As of May 31, 2006, the controlling shareholders held 54.0% of our capital stock. For more information about our controlling shareholders, see "Controlling Shareholders and Related Party Transactions" under Item 7.

Since this acquisition of our capital stock in 1994 and the appointment of our current management, we have grown our revenue base and maintained our profitability every year despite significant challenges. Additionally, we have created a comprehensive network across the region by forming, together with local partners, or acquiring, passenger affiliates in Peru, Ecuador, and Argentina and cargo affiliates in Brazil and Mexico. In early 2004, we changed our corporate image and started using the "LAN" brand in order to better reflect the common values and attributes present in all the companies forming our network. We have complemented our own network with a set of bilateral alliances with carriers such as American Airlines, Iberia and Qantas, and have been a member of the *oneworld*<sup>®</sup> alliance since 2000.

### **Organizational Structure**

LAN is a company primarily involved in the transportation of passengers and cargo. Our operations are carried out principally by Lan Airlines and also by a number of different subsidiaries. As of May 31, 2006, in the passenger business we operated through five main airlines: Lan Airlines, Transporte Aéreo S.A. (which does business under the name "Lan Express"), Lan Peru S.A. ("LanPeru"), Aeroline Líneas Aéreas Nacionales del Ecuador S.A. ("LanEcuador"), and Lan Argentina S.A. ("LanArgentina", previously Aero 2000 S.A.).

In the passenger business we market our sales primarily under the LAN brand. As of May 31, 2006, we held a 99.9% stake in LanExpress through direct and indirect interests, a 70.0% stake in LanPeru through direct and indirect interests, a 45.0% indirect stake in LanEcuador and a 49.0% indirect stake in LanArgentina. For more information, see "—Business of the Company—Regional Expansion" below.

Our cargo operations are carried out by a number of companies, including Lan Airlines and LAN Cargo and are complemented by the operations of certain subsidiaries, such as Aero Transportes Mas de Carga S.A. de C.V., or MasAir, in Mexico and Aerolinhas Brasileiras S.A., or Absa, in Brazil. In the cargo business, we market ourselves primarily under the LAN Cargo brand.

In addition to our air transportation activities, we provide a series of ancillary services. We offer handling services, courier services and logistics, small package and express door-to-door services through Lan Airlines and various subsidiaries.

## Competitive Strengths

Our strategy is to maximize shareholder value by increasing revenues and profitability by leveraging the operational efficiencies between cargo and passenger divisions, thoroughly planning for our expansion efforts and carefully controlling costs. We plan to accomplish these goals both by focusing on our existing competitive strengths and by implementing new strategies to fuel our future growth. We believe our most important competitive strengths are:

### *Leading Airline in Key South American Markets*

We are a market leader in the international and domestic passenger and cargo air services both in Chile and in most of the South American markets that we serve. We have the largest market share of passenger traffic in the international markets to and from Chile, Peru and Ecuador. Within Chile and Peru, we have the leading market share of domestic passenger traffic. We have also achieved a solid and growing position on the Argentine domestic market through LanArgentina and in the international market through our other passenger airlines. We are also the leading air cargo operator within, to and from South America. Our strong and growing operations are based on high-quality services, safety and network efficiency and flexibility.

### *Distinct Integration of Passenger and Cargo*

We believe that one of our distinct competitive advantages is our integrated operations focus, which combines the planning and scheduling of our passenger and cargo operations. The cargo business contributes significantly to our total revenue mix, amounting to 36.3% of total revenues in 2005. This share is among the highest in the global airline industry. Our integrated model is valuable because it maximizes our revenues by transporting cargo in the belly of our passenger flights, therefore lowering our break-even load factors, maximizing our profitability and reducing the volatility of our business over time.

### *Extensive Route Network*

We have developed a distinctive network of cargo and passenger operations based on a set of routes and destinations that connect Latin America with the United States, Europe and the South Pacific operated by our various subsidiaries and affiliates based in Chile, Peru, Ecuador, Argentina, Brazil, and Mexico. This varied and extensive network allows us to diversify our revenue mix and maximize our daily fleet utilization, an important factor in our cost structure. In addition, the use of the unified LAN brand enhances customers' perception of a seamless and consistent travel experience both within our domestic markets and on all of our international routes.

### *Attractive Cost Structure*

We believe we have a highly competitive cost structure with a cost per ATK of 38.8 cents in 2005. Our cost advantage arises mainly from our productive and committed employees, high aircraft utilization, a modern and fuel-efficient fleet and a cost-conscious culture. Our wages and labor costs accounted for approximately 16% of total costs in 2005, a lower percentage than that of other mainline international carriers. Our itineraries and aircraft rotations are designed to maximize aircraft utilization. During 2005, our long-haul aircraft (Boeing 767-300ERs and Airbus A340-300s) operated an average of more than 15 hours per day. We are undergoing a re-fleeting plan that will enable us to modernize aircraft our short and long-haul fleets, as well as to reduce the number of aircraft families that we operate. Finally, our corporate culture promotes constant process streamlining and productivity enhancement.

### *Strong Strategic Alliances*

We are a member of the **oneworld**<sup>®</sup> alliance, and have also entered into bilateral agreements with strategic partners such as American Airlines, Iberia and Qantas, among others, creating a global reach for our passengers. Our passenger alliances and commercial agreements provide our customers with approximately 600 travel destinations, a combined reservations system, itinerary flexibility and various other benefits, which

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substantially enhance our competitive position within the Latin American market. Our strong cargo network is also bolstered by commercial agreements with partners such as Lufthansa Cargo in Europe, American Airlines in the United States, and TAM in Brazil.

### *Flexible Fleet Strategy*

We carefully select our aircraft in order to complement our route network and optimize profitability given that we serve a diverse network of long- and short-haul markets. Our leased fleet is structured with staggered lease maturities over time to create the strategic flexibility to expand or reduce capacity according to market conditions. We believe that our aircraft and the structure of our fleet allow us to maximize aircraft utilization by adapting rapidly to changes in passenger and cargo demand in the markets that we serve.

### **Business Strategy**

The principal areas in which we plan to focus our efforts going forward are as follows:

#### *Leverage the Benefits of Combining our Passenger and Cargo Businesses*

We will continue to leverage the benefits of combining our passenger and cargo operations. Our passenger and cargo operations are equally important aspects of our business, and we dedicate the necessary resources, employees, facilities, management and fleet, to enable both operations to provide high-quality service and to compete effectively in their respective markets. We integrate the two businesses by taking into consideration the potential for cargo services when planning passenger routes, and, when most efficient, maintaining certain dedicated cargo routes using our freighter aircraft. Cargo operations represented 36.3% of our total operating revenues in 2005, and are a significant source of additional revenue on our passenger flights, enabling us to offset fixed operating expenses per flight and thereby improve our profitability on a per flight basis. Additionally, this combination enhances revenue diversification and smoothes seasonal revenue fluctuations.

#### *Maintain High Efficiency Standards*

We maintain a low-cost base due to our productive, flexible and committed personnel, high aircraft utilization and a continuous effort to streamline operations. We have also enhanced direct sales channels to reduce distribution expenses. We will continue to focus on efficiency by increasing our aircraft utilization, streamlining our operations, and reducing commercial costs. Additionally, we plan to increase the efficiency of revenue generation by continuing to use advanced revenue and yield management systems.

#### *Maintain Customer Satisfaction*

In both our passenger and cargo businesses, we focus on delivering high quality services that are valued by our customers. In the passenger businesses we focus on high punctuality rates, reliable operations, world-class on-board service on long-haul flights, quick check-in for short-haul flights and a modern fleet. In the cargo business, we focus on providing reliable service, taking advantage of our ability to handle different types of cargo as well as significant cargo volumes, and leveraging our facilities in key gateways, such as Miami, to ensure optimal handling of our customers' needs. We continually assess opportunities to incorporate service improvements in order to respond effectively to our customers' needs.

#### *Enhance the Value of the LAN Brand*

In March 2004, we created the LAN brand and launched our new corporate image. All of our passenger companies now operate under this brand. By uniting all companies under the LAN alliance concept, we seek to enhance the value of our brand, increase efficiency in marketing efforts, and reinforce the idea of an integrated travel experience across all of the alliance's operators. The rebranding also involved the use of new paint schemes on our aircraft. This process was completed during the first half of 2006.

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### *Build a Comprehensive Network*

We are in the process of developing a broad network across the region. In the passenger business, the LAN alliance consists of companies in Chile, Peru, Ecuador and Argentina, and in the cargo business it includes operators in Chile, Brazil and Mexico. Through this network we are not only able to enhance and diversify our revenue base, but also benefit from complementary traffic flows and seasonal patterns. Our own regional network is complemented by a set of alliances and commercial agreements that strengthen our competitive position and provide customers with access to a global network. We also may grow our network by expanding our operations in other countries.

### *Maintain an Emphasis on Safety*

Our top priority is safety, and we have structured our operations and maintenance to focus on safe flying. Our main maintenance facilities are certified by the FAA, JAA, DGAC and other civil aviation authorities. Our maintenance procedures and our flight operations are certified under ISO 9001-2000 standards. We have programs in place to train our crews and mechanics to world-class standards both at facilities abroad or at the training centers we have developed in association with high-quality partners.

### *Maintain a Solid Financial Position*

We are one of the few investment-grade rated airlines in the world. We seek to maintain our strong financial position by preserving our financial liquidity and continuing to structure long-term financing for newly acquired aircraft. We also monitor and seek opportunities to reduce financial risks associated with currency, interest rate and jet fuel price fluctuations.

## **BUSINESS OF THE COMPANY**

### **Airline Operations and Route Network**

We are one of the main air transport operators in Latin America. As of May 31, 2006, we operated leading passenger airlines in Chile, Peru, Ecuador and Argentina. We are also the largest cargo operator in the region. Our international and domestic passenger and cargo operations and services have increased substantially over the past five years in terms of capacity, traffic and revenue.

The following table sets forth our gross traffic revenues by activity for the periods indicated.

	Year ended December 31,				
	2001	2002	2003	2004	2005
	(in US\$ millions)				
<b>The Company<sup>(1)</sup></b>					
Total passenger revenues	\$ 803.0	\$ 803.7	\$ 918.4	\$1,169.0	\$1,460.6
Total cargo revenues	\$ 539.5	\$ 520.8	\$ 602.0	\$ 799.7	\$ 910.5
Total traffic revenues	\$1,342.5	\$1,324.5	\$1,520.4	\$1,968.7	\$2,371.1

<sup>(1)</sup> Information provided for the Company consolidates LanPeru beginning August 2001, LanEcuador beginning April 2003, LanDominicana beginning June 2003, and LanArgentina beginning June 2005.

### **Passenger Operations**

As of May 31, 2006, our passenger operations were performed through airlines in Chile, Peru, Ecuador and Argentina. We operate international services out of Chile, Peru and Ecuador, as well as domestic flights in Chile, Peru and Argentina. Between June 2003 and May 2004, we also operated international services to and from the Dominican Republic through LanDominicana, which were subsequently suspended due to market conditions.

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As of May 31, 2006, our network consisted of 15 destinations in Chile, 11 destinations in Peru, two destinations in Ecuador, nine destinations in Argentina, ten destinations in other Latin American countries and the Caribbean, three destinations in the United States, two destinations in Europe and four destinations in the South Pacific. Within Latin America we have routes to and from Argentina, Bolivia, Brazil, Chile, Colombia, Cuba, the Dominican Republic, Ecuador, Mexico, Peru, Uruguay and Venezuela. We also fly to a variety of international destinations outside Latin America, including Auckland, Frankfurt, Los Angeles, Madrid, Miami, New York, Papeete (Tahiti) and Sydney. In addition, as of May 31, 2006, through our various code-share agreements, we offer service to 22 additional destinations in North America, 11 additional destinations in Europe, 20 additional destinations in Latin America and the Caribbean (including Mexico), and one destination in Asia.

The following table sets forth certain of our passenger operating statistics for international and domestic routes for the periods indicated. Domestic operations in Chile are classified as “Domestic”, while domestic operations in Peru and Argentina are included in the “International” item.

	Year ended December 31,				
	2001	2002	2003	2004	2005
<b>The Company<sup>(1)</sup></b>					
ASKs (million)					
International	12,904.6	13,011.5	14,505.3	17,389.0	20,025.9
Domestic	3,997.1	4,055.2	3,818.6	3,758.4	3,661.4
Total	16,901.7	17,066.8	18,323.9	21,147.4	23,687.3
RPKs (million)					
International	8,584.9	8,457.8	10,271.5	12,620.5	15,032.9
Domestic	2,694.9	2,681.8	2,399.5	2,504.9	2,457.9
Total	11,279.8	11,139.5	12,671.0	15,125.3	17,490.8
Passengers (thousands)					
International	2,414.7	2,582.3	3,143.5	4,114.6	5,495.8
Domestic	2,821.5	2,734.2	2,365.6	2,464.4	2,471.1
Total	5,236.1	5,316.5	5,509.1	6,578.9	7,966.9
Passenger yield (passenger revenues/ RPKs, in US cents)					
International	US¢6.97	US¢6.86	US¢6.86	US¢7.29	US¢7.77
Domestic	7.90	8.35	8.90	9.95	11.89
Combined yield <sup>(2)</sup>	US¢7.12	US¢7.22	US¢7.25	US¢7.73	US¢8.35
Passenger load factor (%)					
International	66.5%	65.0%	70.8%	72.6%	75.1%
Domestic	67.4	66.1	62.8	66.6	67.1%
Combined load factor <sup>(3)</sup>	66.7%	65.3%	69.1%	71.5%	73.8%

<sup>(1)</sup> Information provided for the Company consolidates LanPeru beginning August 2001, LanEcuador beginning April 2003, LanDominicana beginning June 2003, and LanArgentina beginning June 2005.

<sup>(2)</sup> Aggregate of international and domestic passenger yield.

<sup>(3)</sup> Aggregate of international and domestic passenger load factor.

### *International Passenger Operations*

As of May 2006, we operated scheduled international services from Chile, Peru and Ecuador through Lan Airlines, Lan Express, LanPeru and LanEcuador. International passenger traffic has grown



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significantly due to demand growth, market share gains, increased connecting traffic to and from other Latin American countries, the launch of new routes and expansion into new market and routes.

Our international network combines our Chilean, Peruvian and Ecuadorian affiliates. We have operated international services out of Chile since 1946, and we greatly expanded our flights out of Peru and Ecuador with the creation of LanPeru and LanEcuador in 1999 and 2003, respectively. This strategy is aimed at enhancing our value proposition by offering customers more destinations and routing alternatives, maximizing aircraft utilization, increasing load-factors, leveraging complementary seasonal patterns, and optimizing our commercial efforts. We provide long-haul services out of our three main hubs in Santiago, Lima and Guayaquil. We also provide regional services from Chile, Peru and Ecuador. Since 2004, we have grown our intra-Latin American operations out of Lima to position it as our main regional hub. The following table sets forth the destinations served from each of the aforementioned countries as of May 31, 2006:

<u>Country of Origin</u>	<u>Destination</u>	<u>Number of Destinations</u>
Chile	Argentina	7
	Bolivia	1
	Brazil	2
	Colombia	1
	Cuba	1
	Ecuador	2
	Peru	1
	Uruguay	1
	Venezuela	1
	Dominican Republic	1
	Mexico	2
	United States	3
	Spain	1
	Germany	1
	New Zealand	1
	Australia	1
Peru	Argentina	1
	Chile	1
	Colombia	1
	Ecuador	2
	Venezuela	1
	Mexico	1
Ecuador	United States	3
	Argentina	1
	Chile	1
	Peru	1
	United States	2
	Spain	1

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According to JAC data, Chilean international air passenger traffic increased 9.8% in 2005 as compared to 2004, to approximately 17,937.4 million RPKs. We had a 50.0% market share in 2005, based on RPKs, compared to 49.6% in 2004. Our international operations out of Chile can be divided into four main segments: to North America, to Europe, to the rest of Latin America, and to the Pacific. As of May 31, 2006, the other principal carriers that transport passengers between Chile and North America included American Airlines, Delta Airlines, and Air Canada. Our main competitors on routes between Chile and Europe were Air France, Iberia, Air Madrid and Swiss. On regional routes our main competitors were Aerolineas Argentinas, AeroMexico, Avianca, COPA, TACA, TAM, and Varig. We were the only airline operating between Chile and the South Pacific.

Based on the information provided by the *Corporación Peruana de Aeropuertos y Aviación Comercial S.A.*, or CORPAC, international traffic to and from Peru grew 17.6% between 2004 and 2005 to approximately 3,027.6 thousand passengers. We had a 29% international market share in 2005, based on RPKs, compared to 25% in 2004. Our Peruvian international operations can be divided into two main segments: to North America and to the rest of Latin America. As of May 31, 2006, our main competitors on routes to North America included American Airlines, Continental Airlines, and Delta Airlines. The other principal carriers operating between Peru and the rest of Latin America as of that date included Aerolineas Argentinas, AeroMexico, Avianca, COPA, and TACA.

The Ecuadorian international market (using bookings by IATA travel agencies as proxy for total market size) increased 12.0% to 503.6 thousand passengers between 2004 and 2005. According to travel agency statistics, we had a 21% market share of the Ecuadorian international market in 2005 compared to 22% in 2004. Our Ecuadorian international operations can be divided into three main segments: to North America, to Europe and to the rest of Latin America. As of May 31, 2006, on routes to North America, our main competitors were American Airlines, Continental Airlines and Delta Airlines. On routes to Europe, our main competitors were Air Madrid, Air Plus, Iberia, and KLM. On regional routes, our main competitors were TACA, COPA and Avianca.

### *Domestic Operations in Chile*

Through the companies Lan Airlines and LanExpress we are the leading domestic passenger airline in Chile. We have operated domestic flights in Chile since the Company's creation in 1929. As of May 31, 2006, we flew to 15 destinations within Chile (not including Easter Island, which we treat as an international destination even though it is a part of Chile because we serve it with long-haul aircraft) plus two seasonal destinations. Lan Airlines and LanExpress have integrated passenger operations, including operation under the same two-letter "designator reservation code", and have coordinated fare structures, scheduling and other commercial matters in order to maximize cooperative benefits and revenues for the two carriers. Our strategy is based on providing frequent service to Chile's main destinations, offering a reliable and high quality service, and leveraging our strong brand position in Chile and abroad. We evaluate our network of domestic routes on an ongoing basis in order to achieve optimal operational efficiency and profitability. Our strategic objective is to maintain our leadership position in our domestic routes. As of May 31, 2006 we operate eight Airbus A319/A320 aircraft and 16 Boeing 737-200 aircraft in the Chilean domestic market.

According to JAC data, our domestic market share in Chile was 83.7% for 2004 and 76.0% for 2005. Our main competitors in the domestic market are Sky Airline with a 18.0% market share in 2005 and Aerolineas de Sur with a 5.5% market share in 2005. Sky currently operates a fleet of six Boeing 737-200 and flies to eleven destinations. Aerolineas del Sur, which entered the market in December 2004, is affiliated with Aerolineas Argentina, and operates to six destinations with four Boeing 737-200 aircraft.

There are currently no foreign airlines participating in the Chilean domestic market. However, Chile permits foreign airlines to operate in Chile if the airline's home country gives similar treatment to Chilean airlines. Additionally, there are no regulatory barriers that prevent a foreign airline from creating a Chilean subsidiary and entering the Chilean domestic market using that subsidiary.

### *Domestic Operations in Peru*

Through LanPeru we are the leading domestic passenger airline in Peru. We have operated domestic flights in Peru since the creation of LanPeru in 1999. As of May 31, 2006, we flew to 11 destinations within Peru. In 2004, we were forced to suspend operations following an injunction issued by a Peruvian judge at the request of a former competitor. The suspension lasted approximately 14 hours until we were authorized by a higher court to reinstate service. Also in 2004, in response to changes in the competitive structure of the domestic market, we expanded our operations considerably and thereby expanded our presence in the Peruvian market. Specifically, we added service to four new destinations and incorporated five Airbus A320 aircraft to our domestic operations in Peru. Our strategy is based on delivering high quality service in Peru and providing intensive and convenient service to Peru's main destinations while gradually expanding into new markets. As of May 31, 2006, LanPeru operated with a fleet of seven Airbus A320 aircraft. During the second half of 2006 we plan to gradually replace LanPeru's Airbus A320s for A319s.

According to CORPAC data, our domestic market share in Peru was 42% for 2004 and 66% for 2005. Our main competitors in the Peruvian market during 2005 were Tans, Star Peru, AeroCondor and Taca Peru. AeroContinente ceased operations in July 2004 and in response, LanPeru and a number of smaller airlines expanded their operations. As a result of this expansion, our market share increased significantly from one year to the other. As of May 31, 2006, our main competitors were the same with the addition of one new operator, Wayra Peru.

### *Domestic Operations in Argentina*

LanArgentina initiated service in June 2005. During its first year, Lan Argentina has focused on domestic services. Lan Argentina grew significantly during 2005 as it added more aircraft and new destinations. As of May 31, 2006 LanArgentina operated five Boeing 737-200s. Its itinerary included routes between Buenos Aires and six other domestic destinations. LanArgentina operates in a regulated environment in which fares sold to Argentine passengers are subject to minimum and maximum prices.

In June 2006, LanArgentina initiated the replacement of its Boeing 737 aircraft for Airbus A320 aircraft. This replacement plan is expected to enable LanArgentina to increase the scope, size and efficiency of its operations.

Our domestic market share in Argentina (using bookings by IATA travel agencies as proxy for total market size) for the June-December 2005 period amounted to 11.1%. Our market share grew consistently throughout this period, starting at 6.1% in June and ending at 13.9% in December 2005. Our competitors in the Argentinean market during 2005 were Aerolineas Argentinas and its affiliate Austral. Together, these two companies held substantially all of the remaining share of the domestic Argentine market.

### *Passenger Alliances and Commercial Agreements*

The following are our passenger alliances and partnerships as of May 31, 2006:

- **oneworld®**. In June 2000, Lan Airlines and LanPeru were officially incorporated into the **oneworld®** alliance, a global marketing alliance consisting of American Airlines, British Airways, Cathay Pacific Airlines, Qantas, Iberia, Finnair and Aer Lingus which, among other benefits, offers improved service to frequent flyer customers. Together, these airlines are able to offer customers travel advantages, such as approximately 600 worldwide destinations and schedule flexibility. Additionally, is the first alliance to deploy full interline e-ticketing between its partners. In June 2006, **oneworld®** announced the forthcoming incorporation of three new partners: JAL from Japan, Royal Jordanian from Jordan and Malev from Hungary. These three new airlines are expected to join the alliance in the course of 2007.

- *American Airlines.* Since 1997, Lan Airlines has had an agreement with American Airlines which enables Lan Airlines and American Airlines to share carrier codes for certain flights on global reservations systems, thereby enabling American Airlines passengers to purchase seats on Lan Airlines flights and vice-versa. The Department of Transportation (“DOT”) granted antitrust immunity to our arrangement with American Airlines in October 1999. The antitrust immunity encompasses cooperation in commercial and operational areas such as pricing, scheduling, joint marketing efforts and reductions of airport and purchasing costs, as well as further implementation of cargo synergies in areas such as handling and other airport services. For more information see “—Regulation—U.S. Aeronautical Regulation—Regulatory Authorizations in Connection With Strategic Alliances” below. Through this alliance, we currently offer service to 18 additional destinations in the United States and Canada. In 2005 the DOT granted antitrust immunity to a similar agreement between LanPeru and American Airlines. This antitrust immunity allows enhanced coordination between LanPeru and American Airlines and both companies are currently in the process of developing code-share operations. Also in 2005, American Airlines signed commercial cooperation agreements with LanEcuador and LanArgentina that will enable these two airlines to set up reciprocal accrual and redemption of frequent flyer rewards as well as code-share and/or interline agreements with American Airlines.
- *Iberia.* In January 2001, Lan Airlines initiated a code-share agreement with Iberia, pursuant to which we offer passengers between ten and fourteen non-stop frequencies per week between Santiago and Madrid. In the subsequent years, other destinations were added to the agreement, such as Alicante, Amsterdam, Barcelona, Bilbao, Brussels, London (Heathrow), Malaga, Milan, Paris, Rome, Zurich.
- *Qantas.* In July 2002, Lan Airlines initiated a code-share agreement with Qantas to operate between Santiago, Chile and Sydney, Australia with a stopover in Auckland, New Zealand. As of May 31, 2006, this code-share agreement includes five weekly frequencies operated by Lan Airlines. A sixth weekly frequency is scheduled to begin in the second half of 2006.
- *British Airways.* In August 2000, Lan Airlines initiated a new code-share agreement with British Airways on Lan Airlines flights between Buenos Aires and Santiago. British Airways withdrew from the Chilean market in August 2000, and continues to use the Lan Airlines code-share agreement in order to provide service for its passengers traveling from London to Santiago, through a connection in Buenos Aires. On May 8, 2001, we expanded this code-share agreement to include British Airways’ flights between Madrid and London.
- *Alaska Airlines.* Since 1999, Lan Airlines has been in an alliance with Alaska Airlines Inc. which currently permits us to provide customers with service between Chile and the west coast of the United States and Canada. As part of this code-share agreement, we offer our customers service on Alaska Airlines’ flights to four destinations in the United States and Canada.
- *AeroMexico.* In 2004 we expanded our previous alliance with AeroMexico. The new agreement consists of all of our passenger airlines. Under this alliance, we code-share in flights to Mexico from Chile and Peru, as well as to 10 domestic destinations in Mexico. Additionally, it will provide our passengers with benefits such as easier connections and reciprocal accrual and redemption of frequent flyer program rewards.
- *Mexicana.* In 2004 we signed a new alliance with Mexicana that covers all of our passenger airlines. This agreement provides LAN with 13 additional destinations in Mexico and Central America. Additionally, our passengers will benefit from smoother connections and will be able to accrue and redeem their frequent flyer benefits on LAN’s or Mexicana’s programs.
- *Other alliances and partnerships:* In addition, Lan Airlines has regional code-share agreements with Transportes Aereos del Mercosur S.A. (“TAM Mercosur”) from Santiago to Asunción, Paraguay (which is operated by TAM Mercosur). Since 2005 we have a code-share agreement with Korean Air. Under this agreement we place our code on Korean Air flights between Los Angeles and Seoul, while Korean Air places its code on our flights from Los Angeles to Santiago. In 2005, LAN and JAL signed a frequent flyer program that allows for reciprocal accrual and allowance of frequent flyer benefits.

### *Passenger Marketing and Sales*

Our international and domestic marketing strategy stresses reliability, attentive service, a customer-focused product, comprehensive coverage of key South American markets, and frequent service to major overseas gateways such as New York, Los Angeles, Miami, Madrid, and Sydney. In order to strengthen our market position, we have continued improving our passenger cabins and service and continually monitor our corporate image. For more information on the recent improvements we have made to our cabins and corporate image see “—Business Strategy” below.

Although we have reduced costs in recent years, we have focused on delivering on the attributes valued by customers in order to maintain high levels of customer satisfaction. The latter are continuously monitored by surveys and perception studies that encompassed approximately 700,000 people in 2005. In order to maintain competitive leadership, we have continued to upgrade our aircraft seats and cabins and the in-flight amenities that we provide.

### *Branding*

In March 2004, we launched our new brand “LAN” under which we started to operate all of our international passenger service that we previously operated under the local brands such as “LanChile”, “LanPeru” and “LanEcuador”. Our new brand and corporate image were developed after an extensive process supported by a leading global branding agency. Our corporate image is based on two core concepts: reliability and warmth. We expect that using a single, common brand will enable our customers to better understand the common service and operating standards that exist between our airlines. Additionally, we believe our new image will improve the visibility of our brand, enhance flexibility, and increase the efficiency of our marketing efforts.

This marketing program involved changing our corporate image, including our logo and aircraft paint schemes. As a result, all of our marketing efforts are now done using audiovisual elements based on the LAN brand. During 2005, we focused on advancing the transition to our new brand. This included the gradual repainting of our fleet, which was completed in the second quarter of 2006. Our commercial strategy, centered on exploiting the LAN alliance concept, has been widely recognized, as exemplified by the decision of Airline Business magazine to recognize us in 2004 with its “Airline Strategy Award, Marketing”.

### *Distribution Channels*

We use direct and indirect distribution channels. We have focused on streamlining our distribution strategy in order to reduce costs and enhance the effectiveness of our commercial efforts. This effort has resulted in efficiency gains, and we believe it should lead to further benefits in the future.

Travel agents conduct indirect sales and accounted for approximately 67% of passengers during 2005. We paid these travel agents standard commissions ranging from 0% to 8% depending on the market. Consistent with our efforts to reduce commission costs and in line with current market practices, in recent years we have reduced standard commissions in several markets. In addition to the payment of a base commission, we have supported the growth of our international operations by offering premiums on commissions to agents who sell tickets in excess of certain target amounts.

Travel agents obtain airline travel information and issue airline tickets through Global Distribution Systems (“GDS”) that enable them to make reservations on flights from a large number of airlines. GDSs are also used by travel agents to make hotel and car rental reservations. We participate actively in all major international GDSs, including Sabre, Amadeus, Galileo and Worldspan. In return for access to these systems we pay transaction fees that are generally based on the number of reservations booked through each system.

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Direct channels refer to sales by our own ticket offices, call-centers and website. In 2005, direct bookings accounted for approximately 33% of all of our passengers. We have an extensive sales and marketing network consisting of more than 200 domestic and international points of sale in more than 30 countries.

Our call-centers support the growth of our operations by combining a remote sales channel with personalized service. Our main call-center is located in Santiago and handles calls originated in Chile as well as those in foreign markets such as the United States, Uruguay, Europe, and Mexico. We have additional call-centers in Argentina, Peru, Ecuador and Brazil. These call-centers are complemented by over 180 home-based agents. We have continuously upgraded our systems incorporating technological advances to enhance efficiency and customer service. For example, during 2005 we incorporated voice-recognition technology.

Our website is an integral part of our commercial, marketing and service efforts. In March 2004, we replaced the different country-specific sites (such as *lanchile.cl* or *lanperu.com.pe*) with a unified one, *www.lan.com*, to better reflect the launch of our new corporate image. Together with other direct sales initiatives, our website provides us with a very important tool to reduce our distribution costs. Our internet –related sales have increased significantly in recent years, rising 87% in 2005 compared to 2004, and amounting to approximately US\$90 million in 2005.

Besides serving as a sales channel, we have utilized our website as a tool to provide value-added services and enhance communication. We send weekly promotional e-mails to more than 850,000 subscribers, and members of our frequent flyer program receive their monthly balances and other information by e-mail and can access the data and redeem awards through our website. Additionally, consistent with the LanExpress concept, during 2005 we strongly promoted our Internet-based check-in service for domestic flights. This service allows our passengers to obtain their boarding passes from their home or office, thus avoiding traditional airport counter procedures. In December 2005, around 13% of our domestic passengers were using this system. During April 2006 16.3% of our passenger used this system.

### *Electronic Ticketing*

In 1997, we introduced electronic tickets, commonly referred to as e-tickets, and have since worked to increase their penetration. E-tickets are a key element of our sales efforts through the Internet and our call centers and they also produce important simplifications in our back-office, enabling us to significantly reduce distribution costs. E-tickets, which accounted for approximately 80% of tickets sold during 2005, are currently available in more than 97% of LAN routes. Since 2003, we have advanced in implementing interline e-tickets, and, in line with this effort, in mid-2005 we completed the implementation of this feature with all of our **oneworld**<sup>®</sup> partners. We continue developing interline e-ticket agreements with most of our interline partners.

### *Advertising and Promotional Activities*

Our advertisement and promotional efforts are aimed at enhancing our brand positioning and supporting specific aspects of our commercial efforts. Our advertising and promotional activities include the use of television, print and radio advertisements as well as direct marketing. The utilization of a common brand among our airlines has enabled us to launch regional campaigns focused in highlighting key attributes such as reliability and warmth. During 2005 we deployed two regional campaigns. The first was aimed at reinforcing our positioning. The second one was focused on enhancing awareness about LAN's network and its thorough coverage of South America. These two campaigns used local television and print in Argentina, Chile, Ecuador and Peru, as well as in regional media.

The launch of LanArgentina in 2005 was supported by an intense marketing effort involving television, radio and print. This campaign focused mainly on highlighting the initiation of new domestic operations in Argentina while using the positioning of the LAN brand as an anchor. In Peru we launched campaigns to enhance awareness of attributes such as reliability and differentiating technological advances such as web check-in.

Specific advertisement campaigns were implemented to stimulate internet sales, as well as web-based check-in and service redemption, and enhance low season travel. Additionally, we deployed campaigns to increase awareness of the new routes we launched during the year.

#### *Frequent Flyer Program*

Our frequent flyer program is called LANPASS. LANPASS's objective is to generate incremental revenue and customer retention through customer loyalty and targeted marketing. LANPASS has approximately 1.8 million members. Customers accrue kilometers in their LANPASS accounts based on distance flown and class of ticket purchased. Based on an award schedule, customers can redeem kilometers for free tickets or upgrades. Under our current frequent flyer program, our passengers are grouped into one standard and three different elite levels based on each passenger's flying behavior. These different groups determine which benefits customers are eligible to receive, such as free upgrades on a space-available basis, VIP lounge access, and preferred boarding and check-in.

LANPASS has highly rated partners, including other airlines, hotels, car rental agencies, retailers, and credit card issuers from the main financial institutions in Chile, Peru, Ecuador and Argentina, which give additional kilometers to customers for using their services. As an active member of the **oneworld**<sup>®</sup> alliance, we have reciprocal frequent-flyer agreements with all **oneworld**<sup>®</sup> carriers. In addition, we have reciprocal agreements with other carriers, such as Alaska Airlines, AeroMexico, Mexicana and JAL, that allow us to benefit from the loyalty of their customers, as they can accrue miles under their frequent flyer program when traveling on LAN's flights.

Finally, as part of our frequent flyer program, we have developed a comprehensive database with all flying information from LANPASS customers, plus demographic and other relevant customer information that allows us to generate targeted promotions to different customer segments, reducing dilution and maximizing response rate. This type of information is also a source for customer metrics and monitoring and provides significant management information.

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### Cargo Operations

The following table sets forth certain of our cargo operating statistics for domestic and international routes for the periods indicated.

	Year ended December 31,				
	2001	2002	2003	2004	2005
<b>The Company</b>					
RTKs (millions)					
International	1,809.1	1,788.2	1,876.6	2,226.5	2,359.4
Domestic	44.1	45.6	35.2	32.9	32.8
Total	1,853.2	1,833.8	1,911.9	2,259.4	2,392.3
Weight of cargo carried (millions of tons)					
International	358.6	388.2	397.4	481.3	504.2
Domestic	32.9	32.8	26.8	25.1	24.8
Total	391.5	421.0	424.2	506.3	529.0
Total cargo yield (cargo revenues/RTKs, in US cents)	29.11	28.40	31.49	35.39	38.06
Total cargo load factor (%)	69.2%	67.1%	67.1%	68.7%	66.5%

Our cargo business generated revenues of approximately US\$602.0 million in 2003, US\$799.7 million in 2004 and US\$910.5 in 2005. This represented 36.7%, 38.2% and 36.3% of our operating revenues, respectively. Cargo revenues grew 51.2% between 2003 and 2005 primarily due to the addition of new routes and improvement in yield. Our international cargo routes to, from and within Latin America accounted for approximately 98% of total cargo revenues for 2003, 2004 and 2005.

Our cargo business generally operates on the same route network used by our passenger airline business, which is supplemented by freighter-only operations. Overall, it consists of 71 destinations (56 operated by passenger and/or freighter aircraft and approximately 15 operated only by freighter aircraft). We complement our own operations through coordination with our regional affiliates, MasAir in Mexico, and Absa in Brazil. We also have a minority stake in Florida West International Airways in the United States. We carry cargo for a variety of customers, including other international air carriers, freight-forwarding companies, export oriented companies and individual consumers. For information about our fleet, see “—Fleet—General” below.

We transport cargo in four ways: (i) in the bellies of our passenger aircraft, (ii) in our own dedicated freighter fleet, (iii) in belly space that we purchase from other airlines and, (iv) in aircraft that we charter or lease pursuant to ACMI contracts (Aircraft, Crew, Maintenance and Insurance lease contracts, which are also known as “wet-leases” in which the lessor operates the aircraft and provides the aircraft, crew, maintenance and insurance) pursuant to short- and medium-term contracts.

Our international cargo operations are headquartered in Miami, whose geographical location positions it as the natural gateway for Latin American imports and exports to and from the United States, and since 2001, are centered in our 380,000 square-foot facilities located within the Miami International Airport. The United States accounts for the majority of the cargo traffic to and from Latin America. Besides being the main market for Latin American exports by air, the United States is also the main supplier of goods, such as high-tech equipment or spare parts, transported by air to Latin American countries. To complement our own cargo operations to the United States, we have negotiated commercial agreements with American Airlines on some routes from Miami to Brazil.

We operate to three gateways in Europe: Madrid, which we serve via passenger aircraft (using our flights from Santiago and Guayaquil), Frankfurt (through both passenger flights and freighter operations since October 2002, when we signed our partnership with Lufthansa Cargo (for more information on this agreement see “—Cargo Agreements” below)), and Amsterdam (through freighter operations since October 2005). We also serve Paris through a commercial agreement with TAM, a Brazilian airline.



In Latin America, the principal origins of our cargo are Chile, Ecuador, Peru and Brazil, which represent a large part of our northbound traffic.

Our international cargo traffic increased 30.4% between 2001 and 2005, from 1,809.1 million cargo revenue ton kilometers in 2001 to 2,359.4 million cargo revenue ton kilometers in 2005. We believe that the primary reasons for the growth in cargo operations are:

- increased trade throughout Latin America;
- our expansion and growing presence in new cargo markets;
- a worldwide trend toward greater consumption of fresh fruit, fresh fish and other fresh products;
- commercial agreements with other airlines; and
- a worldwide trend towards reduced inventories.

In general terms, cargo flows are unidirectional. This characteristic is a key determinant of the structure of cargo operations as well as of the commercial conditions in the cargo business. This is especially relevant in markets featuring structural imbalances between inbound and outbound flows or during specific periods of such disequilibrium. Lack of demand in one particular direction may force airlines to rely on different markets in order to maximize loads on return flights. Furthermore, demand weakness in one direction may limit the capacity that is profitable to allocate to some routes, therefore creating pressure on fares in order to compensate for weaker revenues on one particular direction. The evolution of our international cargo operations between 2003 and 2005 was heavily affected by the flow imbalances that the Latin American cargo market experienced during this period.

International cargo traffic increased 4.9% in 2003, increased 21.1% in 2004 and increased 5.9% in 2005. International cargo traffic accounted for approximately 98% of our total cargo revenues during 2003, 2004 and 2005. This period saw a dramatic shift in the relative weight of southbound and northbound cargo flows. The earliest part of this period was characterized by very strong export traffic out of Latin America. Gradual increases in import demand, as well as the deceleration of export growth, led to more balanced cargo flows during 2004. Further extension of this trend led to excess demand on southbound routes.

We have designed our operations, route network and commercial strategies with the flexibility required to respond to changing conditions. As a consequence, during 2003 we allocated additional capacity to northbound routes and adjusted fares on northbound routes in response to excess demand. During 2004 we gradually adjusted our operations to leverage a more balanced demand environment by performing an increased number of direct roundtrips between key export and import markets. However, weakness in exports during 2005 drove us to support the northbound segment of certain routes with stop-overs in additional export markets, to reduce northbound fares to stimulate demand and to raise southbound fares.

During part of this period we also improved our competitive position as key operators, such as AGI and later Arrow, reduced their operations, and competitors such as UPS and FedEx either downsized their operations or exited some markets. Since mid-2004, competition increased as regional carriers added capacity, but despite this increase in competition, we have been able to maintain solid market shares thanks to the utilization of a efficient fleet and a superior network. Today, on Latin America-United States routes, our main competitors are Cielos del Perú S.A., Transportes Aereos Mercantiles Panamericanos S.A., or TAMPA, and Polar Air, and on the Latin American-Europe routes, our main competitors are Cargolux, Lufthansa Cargo, Martinair and Air France.

#### *Cargo Agreements*

Since 2002, LAN Cargo and Lufthansa Cargo have had an agreement to exchange capacity between Europe and Latin America. As part of this agreement, LAN Cargo allocates space to Lufthansa Cargo on its flights between selected cities in Latin America and Europe, and Lufthansa Cargo allocates space to LAN Cargo on its flights between Europe and Brazil and Argentina. In 2004 we enhanced our relationship with Lufthansa Cargo to optimize the provision of cargo handling services at key airports.

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LAN Cargo and TAM (a Brazilian airlines) have an allotment agreement pursuant to which we purchase 100% of the cargo space on TAM's flights between Paris and Sao Paulo. LAN Cargo and American Airlines have an allotment agreement on American's flights between Miami and Sao Paulo.

### *Marketing and Sales*

Our sales and marketing efforts are carried out either directly when we have a local office or through general sales agents. In Latin America we have our own offices in all relevant markets. In the United States we have our own offices in Miami, New York and Los Angeles, and work with representatives in various other cities. In Europe we have offices in Frankfurt, Madrid and Paris and use agents in other relevant cities. Finally, in Asia all our sales efforts are done through general sales agents. In total, we maintain a network of more than 50 independent cargo sales agencies domestically and internationally.

Our cargo marketing strategy emphasizes our combination of freighter and passenger aircraft cargo capacity, which allows customers to ship large, bulky freight, as well as smaller, high-density cargo, fresh produce and other types of cargo. Our cargo marketing strategy also emphasizes our high-quality services, scheduling flexibility and punctuality. On some routes, LAN offers special, value-added products such as Positive Flight Specific ("FS"), which enables the customer to choose a specific passenger flight to transport its goods.

## **Fleet**

### *General*

As of May 31, 2006, we operated a fleet of 76 jet aircraft, comprised of 67 passenger aircraft and nine cargo aircraft, as set forth in the following chart.

	Number of aircraft in operation <sup>(1)</sup>			Average term of lease remaining (years)	Average age (years)
	Total	Owned	Operating lease		
Passenger aircraft					
Boeing 737-200	24	10	14	2.0	26.6
Airbus A319-100	7	2	5	10.1	1.6
Airbus A320-200	15	4	11	5.7	4.8
Boeing 767-300ER	17	4	13	2.1	10.2
Airbus A340-300	4	0	4	6.9	5.1
Total passenger aircraft	67	20	47	4.2	13.7
Cargo aircraft <sup>(1)(2)</sup>					
Boeing 737-200C freighter	1	1	0	—	36.0
Boeing 767-300F freighter	8	7	1	7.5	4.4
Total cargo aircraft	9	8	1	7.5	8.0
Total fleet <sup>(3)</sup>	76	28	48	4.2	13.0

<sup>(1)</sup> We have also historically leased between one and six DC-10 and/or Boeing 747 freighters under short-term ACMI contracts. The number of aircraft leased under such short-term leases has typically fluctuated during the year according to seasonal demand.

<sup>(2)</sup> We have subleased one Boeing 767-300F to Florida West.

<sup>(3)</sup> Does not include one Boeing 767-200 passenger aircraft leased to AeroMexico.

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The daily average hourly utilization rates of our aircraft for each of the periods indicated are set forth below.

	Year ended December 31,		
	2003	2004	2005
	(measured in hours)		
<b>Passenger aircraft</b>			
Airbus A340-300	15.6	16.0	16.0
Boeing 767-300ER	15.4	15.2	14.8
Airbus A320-200	9.2	9.4	9.6
Airbus A319-100 <sup>(1)</sup>	8.7	8.1	8.8
Boeing 737-200	5.3	6.0	6.1
<b>Cargo aircraft</b>			
Boeing 737-200C	3.2	3.4	2.8
Boeing 767-300F	15.6	16.5	16.7

<sup>(1)</sup> We incorporated three and two Airbus A319 into our fleet in the fourth quarters of 2004 and 2005, respectively.

We operate different aircraft type as we perform various different missions ranging from short-haul domestic trips to ultra-long haul trans-Pacific flights. We have selected our aircraft based on the ability to effectively and efficiently serve these missions while trying to minimize the number of aircraft families we operate.

For short-haul domestic and regional flights we operate mainly Boeing 737-200s and Airbus A320-family aircraft. We plan to gradually phase-out our Boeing 737-200s in the next three years, therefore transitioning to an all-Airbus A320 family fleet. However, because we had to rapidly respond to increased capacity requirements due to regional expansion, we incorporated 7 used Boeing 737-200s between 2005 and 2006.

The A320-family aircraft that we currently operate have been acquired pursuant to a purchase agreement signed with Airbus in 1999 and also incorporated pursuant to operating leases. In 2005, we signed an amendment to the purchase agreement with Airbus for 25 A320-family aircraft for delivery between 2006 and 2008. Prior to the signing of this agreement we had outstanding orders for seven Airbus A319 aircraft for delivery between 2006 and 2008 corresponding to a previous purchase agreement. These existing orders were grouped with the new order and as a consequence we currently plan to incorporate 32 Airbus A320-family aircraft between 2006 and 2008. The A320-family includes the A318, A319, A320 and A321 models. Our current plan is to receive 20 Airbus A318s, eight Airbus A319s and four Airbus A320s. We also have options for 15 additional aircraft. Our purchase contracts with Airbus provide for flexibility with regard to future changes in aircraft types and delivery dates. For more information, see “Additional Information—Material Contracts” under Item 10. We believe our fleet of A320-family aircraft will allow us to provide broader service across Latin America as well as the domestic markets that we serve given their longer range. We also believe that they will enable us to increase efficiency levels through reduced fuel consumption and maintenance costs.

For long-haul passenger and cargo flights we operate Boeing 767-300ERs and Boeing 767-300Fs, respectively. We believe that these aircraft’s size and range provide an optimal alternative for most of our long-haul passenger and cargo routes. Additionally, the commonality between the passenger and dedicated cargo versions allows us to leverage the ensuing economies of scale. We believe that these aircraft provide a key efficiency advantage over our peers, especially in the cargo business. The aircraft that we currently operate have been incorporated to our fleet pursuant to operating leases or have been purchased directly from Boeing pursuant to various purchase orders since 1997. Between 2004 and 2006 we placed additional orders

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for 15 Boeing 767-300ER/F aircraft for delivery between 2005 and 2008. The first two aircraft, both freighters, were delivered during the second half of 2005. The third delivery, a passenger aircraft featuring a new upgraded two-class configuration, was completed in March 2006. We plan to receive three additional passenger aircraft and one freighter during the remainder of 2006. Eight passenger Boeing 767-300ERs are currently scheduled for delivery in 2007 and 2008. Our order with Boeing provides for certain flexibility in regards to the aircraft type to be received.

We operate four Airbus A340-300 aircraft for long-haul routes. Given their range and four-engine configuration these aircraft are well-suited to perform trans-Atlantic and trans-Pacific missions out of Santiago.

From time to time, we also decide to purchase used aircraft for opportunistic and economic reasons. Because of the attractiveness of the purchase price compared to the cost of continuing to lease the aircraft, we acquired one DC-8 in 2003 that was previously leased to LAN. The latter was sold in 2004. In 2003, we converted one of our Boeing 737-200 passenger aircraft into a freighter to serve domestic routes.

Historically, we have also utilized between one and five cargo aircraft pursuant to short-term ACMI leases. These contracts enable us to adjust capacity on a short- to medium-term basis in order to manage the volatility of the demand for cargo services and increased access to certain cargo destinations. As of May 31, 2006, we were utilizing one Boeing 747 freighter and one DC-10 aircraft under ACMI leases from different suppliers. Our current ACMI contracts are for a one-year periods.

### *Fleet Leasing and Financing Arrangements*

Our financing and leasing methods include borrowing from financial institutions and leasing under financial leases, tax leases and operating leases.

Between 1998 and 2001 LAN acquired eight Boeing 767s, which were fully financed by three separate syndicated credits backed by U.S. Export-Import Bank ("Ex-Im Bank") guarantees. While four of the planes were financed utilizing twelve-year payment profiles, the payment profiles of the remaining four were successfully extended to 15 years through the use of mismatch structures. This extension made LAN the first airline to receive this type of financing with Ex-Im Bank support.

In 2004 and 2005 LAN ordered 12 Boeing 767-300s for delivery between 2005 and 2008. In 2004 the company structured a new syndicated facility for approximately US\$250 million to finance the entire cost of the two Boeing 767-300Fs delivered in 2005 and the first Boeing 767-300ER delivered in 2006. These loans were also guaranteed by Ex-Im Bank for 85% of the total amount and had a 12-year term. In 2005 LAN also finalized two new syndicated facility to fund the purchase of nine Boeing 767-300ER/F aircraft for reception in 2006-2008. Both loans are guaranteed by Ex-Im Bank with a twelve-year term. The first facility covers 85% of the value of each of the last four deliveries of 2006, while the second one will finance 85% of each of the remaining five aircraft, scheduled for delivery in 2007 and 2008.

In 2006 the Company ordered three additional Boeing 767-300ERs aircraft for delivery in 2007 and 2008. These aircraft will be financed through a new Ex-Im Bank-syndicated facility structured in the first half of 2006. These loans will finance 85% of the purchase price of each aircraft and feature a 12-year repayment profiles. An additional facility will support pre-delivery payments for these three aircraft.

In 2000, to finance our Airbus aircraft, we entered into a US\$1.3 billion umbrella credit facility with a syndicate of international financial institutions under which we borrowed in the form of separate loans in connection with the specific financing requirements of each Airbus aircraft (including pre-delivery and long-term financing). This umbrella facility provided for guarantees from the English, French and German Export Credit Agencies ("ECA"). Our repayment profile for each aircraft financed under the facility was of up to 18 years. Under this financing package we incorporated into our fleet Airbus aircraft through operating leases, financial leases and tax leases. Even though this facility covered the aircraft scheduled to be delivered under our 1998/9 Airbus purchase agreements through December 31, 2006, we decided to fund the remaining 2006 deliveries with a new facility negotiated in 2006.

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This new facility will finance the acquisition of 32 Airbus A320-family aircraft between 2006 and 2008. This new US\$920 million facility will be similar to the previous one as we will draw separate loans in connection with the specific financing requirements of each Airbus aircraft. This facility is based on support guarantees from the English, French and German Export Credit Agencies. Under this financing package we will incorporate into our fleet Airbus aircraft through operating leases, financial leases and tax leases. The facility will cover 85% of the purchase price of each aircraft plus the associated ECA premium. The remaining 15% will be funded directly by LAN.

On June 12, 2005, we made the final payment with respect to a Boeing 767-200 aircraft we held under a capital lease. We sublease this aircraft to a third party at a market rate and recently extended this sublease until May 2007.

As of May 31, 2006, we held 48 aircraft under operating leases. Under the terms of our operating leases, we are required to return the aircraft in an agreed upon condition at the end of the lease. Although the title to the aircraft remains with the lessor, we are responsible during the lease term for the maintenance, servicing, insurance, repair and overhaul of the aircraft. As of December 31, 2005, aggregate future minimum lease payments required under our aircraft operating leases were US\$856.3 million. Our operating leases have terms ranging from three to 12 years from the date of delivery of the aircraft. For more information, see Note 17 to our audited consolidated financial statements.

## **Maintenance and Safety**

### *Maintenance*

Our heavy maintenance, line maintenance and component shop capabilities are equipped to service our entire fleet of Airbus and Boeing aircraft. Our maintenance capabilities allow us flexibility in scheduling airframe maintenance, offering us an alternative to third-party maintenance providers.

Our maintenance base at the Arturo Merino Benítez International Airport in Santiago, Chile is among the most extensive in Latin America and has been certified as an FAA and JAA approved repair station. Our hangars at our Santiago repair station can service four narrow-body and two wide-body aircraft simultaneously, and contain maintenance workshops for repairing avionics, hydraulics and pneumatics components. In addition, we have facilities for designing and manufacturing galleys, structures and composite materials, and we have the capability to retrofit aircraft interiors, including sophisticated in-flight entertainment equipment.

Our engineering and maintenance division is subjected to multiple recurrent external audits from aviation authorities such as the Chilean DGAC, the FAA, the European JAA, the Argentine DNA, and the Brazilian DAC. The audits were conducted in connection with each country's certification procedures and enable us to continue to perform maintenance for aircraft registered in the certifying jurisdictions. Our engineering and maintenance division is ISO 9001-2000 certified and holds FAA and EASA Part-145 certifications.

We also rely on third parties for certain maintenance of our aircraft and engines. Lufthansa Technik provides our Airbus A320-family and A340 component support on a power-by-the-hour basis under a long term contract, which runs until 2013. International Aero Engines provides the A320 engine support on a power-by-the-hour contract, which runs for 12 years once each engine is received. General Electric provides the maintenance of our Airbus A340 engines under a similar contract, which runs until 2013. The maintenance of most of our Boeing 767 engines is provided by General Electric. Substantially all of our other engine maintenance is also provided by third parties. Our Boeing 767-components are maintained by AirFrance-KLM under a 10-year total component support contract. We are also outsourcing some heavy maintenance work to qualified stations in South America.

We occasionally perform certain maintenance services for other airlines. Our aircraft maintenance personnel participate in extensive training programs at the jointly-operated Lufthansa LAN Technical Training S.A.

### *Safety*

We place a high priority on providing safe and reliable air service, as it is considered a fundamental asset to LAN and one of the basic pillars for the development of our company. We have uniform safety standards and safety-related training programs that cover all of our operations. Our safety area focuses on four main areas:

- Flight Safety
- Maintenance Safety
- Airport and Airside Safety
- Cargo Safety

In particular, we periodically evaluate the skills, experience and safety records of our pilots in order to maintain strict control over the quality of our pilot crews. All of our aircraft pilots participate in training programs, some of which are sponsored by aircraft manufacturers, and all are required to undergo recurrent training. For more information, see “Directors, Senior Management and Employees—Employees” under Item 6.

The main Safety programs and procedures currently being implemented in the company are the following:

1. Flight Operations Quality Assurance (“FOQA”): since the end of 2002, LAN has been implementing a Flight Data Monitoring program using mainly two different analysis programs (FLIDRAS and AGS), along with a similar Maintenance program (“MOQA”), which monitors the engines, flight controls and general performance of the aircraft;
2. Mandatory Occurrence Reports (“MOR”);
3. Confidential Reports Program (voluntary), can be sent directly to the safety area by a paper form or a digital form available in intranet with absolute confidentiality;
4. All Safety information regarding all occurrences are entered in a dedicated software (“AVSIS”), where analysis is performed regarding their potential risks;
5. Changes in operating processes are analyzed to evaluate and minimize risks

Finally, there is an *Operational Safety Committee* that meets every month and is composed of senior executives and key operational managers. The main task of this committee is to agree and empower safety actions required to reduce risk.

Since 1991, we have had no accidents involving major injury to passengers, crew or aircraft.

### **Fuel Supplies**

The availability and cost of jet fuel have a significant impact on our results of operations. Fuel costs represented approximately 17.0%, 21.6% and 27.2% of our operating expenses 2003, 2004 and 2005, respectively. In 2005, we purchased a substantial portion of the fuel for our domestic flights in Chile and a portion of the fuel for our international flights through one-year renewable contracts with Air BP-COPEC, Exxon Mobil Aviation and Repsol YPF. We also purchase a portion of the fuel for our international flights from foreign fuel suppliers located at the destinations of those flights, at international market prices. In Peru, we purchase our fuel mainly from Repsol YPF, Exxon Mobil and Petroperu. In Ecuador, we purchase our fuel mainly from Repsol YPF. In the United States, we purchase our fuel mainly from Shell, Chevron, Air BP, CITGO (through traders) and Glencore.

Over the last few years, our fuel consumption and expenses have increased primarily as a result of increases in our operations. Fuel efficiency (measured as fuel consumption per ATK) has improved marginally in 2005 due to the utilization of newer aircraft. Fuel prices are influenced by economic and political factors and events occurring throughout the world, and this has led to significant volatility. In 2005, fuel costs increased 55.0% due to a 40.7% increase in average fuel prices for the year and 9.8% increase in

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consumption. We can neither control nor accurately predict fuel prices; however, we offset our price variation risk, in part, through our jet fuel hedging program and the application of a cargo fuel surcharge. For more information, see “Quantitative and Qualitative Disclosures About Market Risk—Risk of Fluctuation in Jet Fuel Prices” under Item 11.

The following table details our consolidated fuel consumption and operating costs (which exclude fuel costs related to charter operations in which fuel expenses are covered by the entity that charters the flight).

	Year ended December 31,				
	2001	2002	2003	2004	2005
Fuel consumption (thousands of gallons)	244,891.6	245,456.5	261,147.2	308,015.0	338,275.1
ATKs (millions)	4,212.5	4,281.8	4,539.2	5,256.2	5,810.8
Fuel consumption per ATK (thousands of gallons)	0.06	0.06	0.06	0.06	0.06
Total fuel costs (US\$ thousands)	US\$ 222,402	US\$ 205,524	US\$ 259,566	US\$ 414,539	US\$ 642,696
Cost per gallon (US\$) <sup>(1)</sup>	US\$ 0.91	US\$ 0.84	US\$ 0.99	US\$ 1.35	US\$ 1.90
Total fuel costs as a percentage of total operating costs	16.1%	14.8%	17.0%	21.6%	27.2%

<sup>(1)</sup> Average price paid per gallon on fuel.

## Ground Facilities and Services

Our main operations are based at the Arturo Merino Benítez International Airport in Santiago, Chile. We also operate from various other airports in Chile and abroad. We operate hangars, aircraft parking and other airport service facilities at the Arturo Merino Benítez International Airport and other airports throughout Chile pursuant to concessions granted by the DGAC. We also maintain two customs warehouses at the Arturo Merino Benítez International Airport, additional customs warehouses in Chile (Iquique, Antofagasta, and Punta Arenas) and Argentina (Rosario) and operate cargo warehouses at the Miami International Airport to service our cargo customers. Our facilities at Miami International Airport include corporate offices for our cargo and passenger operations and temperature-controlled and freezer space for imports and exports.

We have VIP lounges at the Arturo Merino Benítez International Airport. The 7,500 square foot Neruda lounge represented an investment of US\$600,000 and has been widely acclaimed, and in 2005, *Latin Trade* magazine selected it as the “Best Airline Lounge” in Latin America.

Finally, we incur certain airport usage fees and other charges for services performed by the various airports where we operate, such as air traffic control charges, take-off and landing fees, aircraft parking fees and fees payable in connection with the use of passenger waiting rooms and check-in counter space.

## Ancillary Airline Activities

In addition to our airline operations, we generate revenues from a variety of other activities. In 2005, LAN generated other revenues of US\$135.3 million.

Our total revenue from aircraft leases (including subleases to certain of our cargo affiliates, dry-leases, wet-leases and capacity sales to alliance partners) and charter flights, amounted to US\$23.8 million in 2005.

LAN also provides cargo-related services such as courier, warehousing, fulfillment and customs services, through various subsidiaries. Through our subsidiary LanCourier we operate vans and trucks and offer distribution and warehouse services throughout Chile. By using tracking and Internet technology, LanCourier customers have real-time access to data regarding the status of their parcels. LanLogistics is a

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LAN Cargo subsidiary dedicated to the development of higher-value door-to-door express cargo products and services between Latin America and the United States. LanLogistics operates through different subsidiaries and brands, such as LanBox and SkyBox for the Internet-based fulfillment services and as SkyNet for the international courier services. During 2005, our logistics and courier businesses generated revenues of approximately US\$39.9 million. We also have storage and customs brokerage operations that generated revenues of approximately US\$10.7 million.

During 2005, we also had revenues of US\$18.8 million for ground services and US\$15.6 million for duty-free in-flight sales. The balance of our operating revenues (US\$26.4 million in 2005) was generated by sales to third parties by Amadeus Chile CRS (computer reservation system), aircraft maintenance services to third parties, our security services business, tour operations, and other activities.

### **Insurance**

We carry hull insurance that includes, among other coverage, “all risk”, war and allied risks, spares and liability for passengers, cargo, mail, baggage and third parties. We renew our insurance coverage yearly, and are subject to deductibles that vary depending on the type of coverage and the type of loss. Our deductibles are US\$1,250 for loss or damage associated with passengers’ baggage liabilities, US\$10,000 for loss or damage associated with cargo liabilities and US\$1.0 million for hull “all risk” insurance for Boeing 767 and Airbus A340 aircraft. Additionally, we have hull deductible coverage to reduce the net deductible to US\$100,000 per occurrence (aircraft and/or engine).

Our insurance coverage has a one-year term ending in December of each year. The aggregate cost of our insurance coverage for the 2005 calendar year was US\$ 12.7 million, which represents a 13.0% decrease in insurance expenses and 19.7% decrease in average insurance rates compared to the 2004 calendar year. The annual insurance cost has been consistently reduced over the last three years, due to improved insurance market conditions as well as LAN’s excellent loss ratios.

### **Information Technology**

We use information technology in virtually every aspect of our business.

With the exception of our reservations, departure control (check-in), inventory, flight planning and baggage tracing systems, which are operated by Amadeus, Iberia and SITA, we operate our systems from two data center facilities in Santiago.

Third party suppliers provide us with the following technical infrastructure elements:

- wide-area data network (provided mainly by SITA); and
- data centers and desktop operations and support (provided by EDS).

#### *Basic Infrastructure Operation*

Since early 2003, we have outsourced our IT infrastructure management to EDS. This service includes the administration and support of the data centers and desktop equipment. EDS’s assistance has enabled us to:

- increase the efficiency of our IT operations;
- convert fixed costs into variable costs;
- guarantee that the service standards (such as up-time and response time) required by critical processes of our business are fulfilled;
- accelerate critical infrastructure projects while significantly reducing the resources required;
- increase the efficiency of our personnel; and
- focus internal IT efforts on business functions, rather than basic hardware and software issues.



### *Telecommunications*

We have used the latest technology available with regard to our global telecommunications network. We have redesigned our network by combining traditional private data channels with virtual private networks through the Internet. The program also involves voice transmission through data-channels. This initiative has enabled us to reduce our communications expenses significantly.

### *Front End Systems*

During 2002, we deployed new systems to support our sales personnel. These systems provide the employees who deal directly with our customers with additional tools to improve service, enhance customer information and increase efficiency. During 2004 and 2005, we implemented these systems at our airport counters and our call centers.

### *Enterprise Resource Planning*

In 2002, we purchased an enterprise resource planning (“ERP”) system from SAP. This system was fully implemented in the second quarter of 2004 in Lan Airlines and almost all of its subsidiaries. This ERP system includes modules covering areas such as: finance, accounting, inventory management, human resources, business warehouse, as well as a user-friendly portal. We are currently working in optimizing and simplifying this system, and in leveraging it to increase the efficiency of our back-office processes.

## **Regulation**

### *Chilean Aeronautical Regulation*

Both the DGAC and the JAC oversee and regulate the Chilean aviation industry. The DGAC reports directly to the Chilean Air Force and is responsible for supervising compliance with Chilean laws and regulations relating to air navigation. The JAC is the Chilean civil aviation authority. Primarily on the basis of Decree Law No. 2,564, which regulates commercial aviation, the JAC regulates the assignment of domestic and international routes, and the DGAC regulates flight operations, including personnel, aircraft and security standards, air traffic control and airport management. We have obtained and maintain the necessary authority from the Chilean government to conduct flight operations, including authorization certificates from the JAC and technical operative certificates from the DGAC, the continuation of which is subject to the ongoing compliance with applicable statutes, rules and regulations pertaining to the airline industry, including any rules and regulations that may be adopted in the future.

Chile is a contracting state, as well as a permanent member, of the International Civil Aviation Organization, or the ICAO, an agency of the United Nations established in 1947 to assist in the planning and development of international air transport. The ICAO establishes technical standards for the international aviation industry, which Chilean authorities have incorporated into Chilean laws and regulations. In the absence of an applicable Chilean regulation concerning safety or maintenance, the DGAC has incorporated by reference the majority of the ICAO’s technical standards. We believe that we are in material compliance with all relevant technical standards.

### *Route Rights*

*Domestic Routes.* Chilean airlines are not required to obtain permits in connection with carrying passengers or cargo on any domestic routes. Non-Chilean airlines are permitted to provide domestic air service between destinations in Chile, provided that the country in which the foreign airline is based grants a reciprocal right to Chilean airlines. There are no regulatory barriers, however, that would prevent a foreign airline from creating a Chilean subsidiary and entering the Chilean domestic market using that subsidiary.

*International Routes.* As an airline providing services on international routes, Lan Airlines is also subject to a variety of bilateral civil air transport agreements that provide for the exchange of air traffic rights between Chile and various other countries. There can be no assurance that existing bilateral agreements

between Chile and foreign governments will continue, and a modification, suspension or revocation of one or more bilateral treaties could have a material adverse effect on our operations and financial results.

International route rights, as well as the corresponding landing rights, are derived from a variety of air transport agreements negotiated between Chile and foreign governments. Under such agreements, the government of one country grants another government the right to designate one or more of its domestic airlines to operate scheduled services between certain destinations in that country. In Chile, when additional route frequencies to and from foreign cities become available, any eligible airline may apply to obtain them. If there is more than one applicant for a route frequency the JAC awards it through a public auction for a period of five years. The JAC grants route frequencies subject to the condition that recipient airline operate them on a permanent basis. If an airline fails to operate a route for a period of six months or more, the JAC may terminate its rights to that route. International route frequencies are freely transferable. In the past, we have generally paid only nominal amounts for international route frequencies obtained in uncontested auctions. We made no material payments for international routes during 2005.

*Air Fare Pricing Policy.* Chilean airlines are permitted to establish their own domestic and international fares without government regulation, as long as they do not abuse any dominant market position they may enjoy. For more information, see “Antitrust Regulation” below. Airlines may file complaints before the Antitrust Commission with respect to monopolistic or other pricing practices by other airlines that violate Chile’s antitrust laws. In 1997, the Antitrust Commission approved and imposed a specific self-regulatory fare plan for our domestic operations consistent with the Antitrust Commission’s directive to maintain a competitive environment. According to this plan, we must file notice with the JAC of any increase or decrease in standard fares on routes deemed “non-competitive” by the JAC and any decrease in fares on “competitive” routes at least twenty days in advance. We must file notice with the JAC of any increase in fares on “competitive” routes at least ten days in advance. In addition, the Chilean authorities now require that we justify any modification that we make to our fares on non-competitive routes. We must also ensure that our average yields on a non-competitive route are not higher than those on competitive routes of similar distance. As of March 31, 2006, 64% of the domestic routes that we operate had been classified as “non-competitive” and were subject to the requirements described above.

*Registration of Aircraft.* Aircraft registration in Chile is governed by the Chilean Aeronautical Code. In order to register or continue to be registered in Chile, an aircraft must be wholly-owned by either:

- a natural person who is a Chilean citizen; or
- a legal entity incorporated in and having its domicile and principal place of business in Chile and a majority of the capital stock of which is owned by Chilean nationals.

The Aeronautical Code expressly allows the DGAC to permit registration of aircraft belonging to non-Chilean individuals or entities with a permanent place of business in Chile. Aircraft owned by non-Chileans, but operated by Chileans or by an airline which is affiliated with a Chilean aviation entity, may also be registered in Chile. Registration of any aircraft can be cancelled if it is not in compliance with the requirements for registration and, in particular, if:

- the ownership requirements are not met; or
- the aircraft does not comply with any applicable safety requirements specified by the DGAC.

*Safety.* The DGAC requires that all aircraft operated by Chilean airlines be registered either with the DGAC or with an equivalent supervisory body in a country other than Chile, so long as that country is a member of the Warsaw Convention. All aircraft must have a valid certificate of airworthiness issued by either the DGAC or an equivalent non-Chilean supervisory entity. In addition, the DGAC will not issue maintenance permits to a Chilean airline until the DGAC has assessed the airline’s maintenance capabilities. The DGAC renews maintenance permits annually, and has approved our maintenance operations. Only DGAC-certified maintenance facilities or facilities certified by an equivalent non-Chilean supervisory body in the country where the aircraft is registered may maintain and repair the aircraft operated by Chilean airlines. Aircraft

maintenance personnel at such facilities must also be certified either by the DGAC or an equivalent non-Chilean supervisory body before assuming any aircraft maintenance positions.

*Security.* The DGAC establishes and supervises the implementation of security standards and regulations for the Chilean commercial aviation industry. Such standards and regulations are based on standards developed by international commercial aviation organizations. Each airline and airport in Chile must submit an aviation security handbook to the DGAC describing its security procedures for the day-to-day operations of commercial aviation and procedures for staff security training. Lan Airlines has submitted its aviation security handbook to the DGAC. Chilean airlines that operate international routes must also adopt security measures in accordance with the requirements of applicable bilateral international agreements.

*Chilean Airport Policy.* The DGAC supervises and manages airports in Chile, including the supervision of take-off and landing charges. The DGAC proposes airport charges, which are approved by the JAC and are the same at all airports. Since the mid-90s, a number of Chilean airports have been privatized, including the Arturo Merino Benítez International Airport in Santiago. At the privatized airports, the airport administration manages the facilities under the supervision of the DGAC and JAC.

*Environmental and Noise Regulation.* There are no material environmental regulations or controls imposed upon airlines, applicable to aircraft, or that otherwise affect us in Chile, except for environmental laws and regulations of general applicability. There is no noise restriction regulation currently applicable to aircraft in Chile. However, Chilean authorities are planning to pass a noise-related regulation governing aircraft that fly to and within Chile. The proposed regulation will require all such aircraft to comply with certain noise restrictions, referred to in the market as Stage 3 standards. The majority of LAN's fleet already complies with the proposed restrictions.

#### *Regional Aeronautical Regulation (Brazil, Ecuador, Mexico and Peru)*

Our subsidiaries operate throughout the Latin American region under the routes granted by the relevant authorities in each jurisdiction where they are based.

*International Routes.* Under Brazilian, Ecuadorian, Mexican and Peruvian laws, international route rights, as well as the corresponding landing rights, are granted under air transport agreements negotiated directly between the relevant home jurisdiction and foreign governments.

*Domestic Routes.* Under Brazilian, Chilean and Mexican regulations, domestic airlines are not required to obtain permits in connection with carrying passengers or cargo on any domestic routes. However, Peruvian law requires the consent of Peruvian authorities to fly a determined domestic route, and Ecuadorian law requires the airline to obtain a specific concession to fly domestically.

#### *U.S. Aeronautical Regulation*

*General.* Flight operations between Chile and the United States by airlines licensed by either country are governed generally by the open skies air transport agreement that Chile and the United States signed in October 1997. Under the open skies agreement, there are no restrictions on the number of destinations or flights that either a U.S. or a Chilean airline may operate between the two countries or on the number of U.S. and Chilean airlines that may operate. Operations to the United States by non-U.S. airlines, such as Lan Airlines, are subject to Title 49 of the U.S. Code, under which the DOT and the FAA exercise regulatory authority. The U.S. Department of Justice also has jurisdiction over airline competition matters under the federal antitrust laws.

*Authorizations and Licenses.* The DOT has jurisdiction over international aviation with respect to the United States and related route authorities, subject to review by the President of the United States. The DOT also has jurisdiction with respect to unfair practices and methods of competition by airlines and related consumer protection matters. Lan Airlines is authorized by the DOT to engage in scheduled and charter air transportation services, including the transportation of persons, property (cargo) and mail, or combinations thereof, between points in Chile and points in the United States and beyond (via intermediate points in other countries). We hold the necessary authorizations from the DOT in the form of a foreign air carrier permit, an

exemption authority and statements of authorization to conduct our current operations to and from the United States. Exemptions and statements of authorization are temporary in nature and are subject to renewal and therefore there can be no assurance that any particular exemption or statement of authorization will be renewed. Our foreign air carrier permit has no expiration date, while our exemption authority (which includes the open skies traffic rights) was set to expire on November 26, 2005, but a renewal application was timely filed and is pending before the DOT. The exemption authority is automatically extended until such time as the DOT issues the renewal order. We plan to amend our foreign air carrier permit to include the open skies rights, which would eliminate our need to renew the exemption authority in the future.

In the United States, we are subject to the FAA's regulation with respect to safety matters, including aircraft maintenance and operations, equipment, aircraft noise, ground facilities, dispatch, communications, personnel, training, weather observation and other matters affecting air safety. The FAA requires each foreign air carrier to obtain certain operations specifications that authorize it to operate to particular airports on approved international routes using specified equipment. Lan Airlines currently holds FAA operations specifications under Part 129 of the Federal Aviation Regulations. We believe that we are in compliance in all material respects with all requirements necessary to maintain in good standing our operations specifications issued by the FAA. The FAA can amend, suspend, revoke or terminate those specifications, or can suspend temporarily or revoke permanently our authority if we fail to comply with the regulations, and can assess civil penalties for such failure. A modification, suspension or revocation of any of our DOT authorizations or FAA operations specifications could have a material adverse effect on our business.

The FAA also conducts safety audits and has the power to impose fines and other sanctions for violations of airline safety regulations. We have not incurred any material fines related to operations.

*Security.* On November 19, 2001, Congress of the United States passed, and the President signed into law, the Aviation and Transportation Security Act, also referred to as the Aviation Security Act. This law federalized substantially all aspects of civil aviation security and created the Transportation Security Administration, or TSA, which took over security responsibilities previously held by the FAA. The TSA is an agency of the U.S. Department of Homeland Security. The Aviation Security Act requires, among other things, the implementation of certain security measures by airlines and airports, such as the requirement that all passenger bags be screened for explosives. Funding for airline and airport security required under the Aviation Security Act is provided in part by a US\$2.50 per segment passenger security fee, subject to a US\$10 per roundtrip cap; however, airlines are responsible for costs in excess of this fee. Implementation of the requirements of the Aviation Security Act has resulted in increased costs for airlines and their passengers. Since the events of September 11, 2001, Congress has mandated and the TSA has implemented numerous security procedures and requirements that have imposed and will continue to impose burdens on airlines, passengers and shippers.

*Noise Restrictions.* Under the Airport Noise and Capacity Act of 1990, or ANCA, and related FAA regulations, aircraft that fly to the United States must comply with certain Stage 3 noise restrictions, which are currently the most stringent FAA noise requirements. All of our aircraft that fly to the United States meet the Stage 3 requirements.

Under the direction of the ICAO, governments are considering the creation of a new and more stringent noise standard than that contained in the ANCA. The ICAO adopted new noise standards in 2001 that established more stringent noise requirements for aircraft manufactured after January 1, 2006. In the U.S., legislation known as the "Vision 100 – Century of Aviation Reauthorization Act", which was signed into law in December 2003, requires the FAA, by April 1, 2005, to issue regulations implementing Stage 4 noise standards consistent with recommendations adopted by the ICAO. In December 2003, the FAA issued a proposed rule that would implement such standards.

FAA regulations also require compliance with the Traffic Alert and Collision Avoidance System, approved airborne wind shear warning system and aging aircraft regulations. Our fleet meets these requirements.

*Airport Slot Restrictions.* Four U.S. airports - Chicago O'Hare, LaGuardia (New York), John F. Kennedy International (New York) and Reagan National (Washington, D.C.) - have been designated by the FAA as "high density traffic airports". Operations at these airports are or have been subject to slot restrictions during certain periods of the day. A "slot" is an authorization to take off or land at a designated airport within a specified time window. Legislation passed in March 2000 resulted in the elimination of slot restrictions at Chicago O'Hare on July 1, 2002 and at LaGuardia and Kennedy International on January 1, 2007. Of these airports, LAN currently operates only to JFK. In the past, we have generally been successful in obtaining the slots we need to conduct our planned operations at JFK. However, slots are requested by carriers and allocated by the FAA on a seasonal basis, and there can be no assurance that we will be able to obtain all requested slots in the future because, among other factors, government policies regulating the distribution of slots are subject to change.

*Proposed Laws and Regulations.* Additional U.S. laws and regulations have been proposed from time to time that could significantly increase the cost of airline operations by imposing additional requirements or restrictions on airline companies. Laws and regulations have been considered from time to time that would prohibit or restrict the ownership and transfer of airline routes or slots. There can be no assurance that laws and regulations currently enacted or enacted in the future will not adversely affect our ability to maintain our current level of operating results.

#### *Regulatory Authorizations in Connection with Strategic Alliances*

The alliance between Lan Airlines and American Airlines includes three major components: a frequent flyer agreement, a reciprocal code-share agreement and the coordination of pricing, scheduling and other functions. The last two of these items required the approval of regulatory authorities in both Chile and the United States. With respect to the code-share agreement, the open skies agreement between Chile and the United States expressly permits code-sharing operations by U.S. and Chilean airlines. With regard to the coordination of pricing and scheduling, Lan Airlines and American Airlines filed a joint application with the DOT in December 1997, requesting approval of their alliance agreement and immunity from the application of all U.S. antitrust laws pursuant to Title 49 of the U.S. Code. Lan Airlines and American Airlines received approval and antitrust immunity from the DOT in September 1999, and implemented the code-share agreement in October 1999. In accordance with the terms of the DOT's 1999 approval, Lan Airlines and American Airlines were required to resubmit their alliance agreement to the DOT for review within three years after the DOT's grant of approval. Lan Airlines and American Airlines resubmitted the agreement in September 2002 and did not receive any comments from the DOT. The approval and antitrust immunity remain in effect, and there is no further obligation to submit the agreement to the DOT for review.

#### *Antitrust Regulation*

The Chilean antitrust authority, which we refer to as the Antitrust Court (previously the Antitrust Commission), oversees antitrust matters, which are governed by Decree Law No. 211 of 1973, as amended, or the Antitrust Law. The Antitrust Law prohibits any entity from preventing, restricting or distorting competition in any market or any part of any market. The Antitrust Law also prohibits any business or businesses that have a dominant position in any market or a substantial part of any market from abusing that dominant position. An aggrieved person may sue for damages arising from a breach of Antitrust Law and/or file a complaint with the Antitrust Court requesting an order to enjoin the violation of the Antitrust Law. The Antitrust Court has the authority to impose a variety of sanctions for violations of the Antitrust Law, including termination of contracts contrary to the Antitrust Law, dissolution of a company and imposition of fines and daily penalties on businesses. Courts may award damages and other remedies (such as an injunction) in appropriate circumstances. Lan Airlines, LanExpress and Lan Cargo must comply with Chilean Antitrust Law that prohibits a carrier from abusing a dominant position in the market. As described above under "Route Rights—Air Fare Pricing Policy", in October 1997, the Antitrust Commission approved a specific self-regulatory fare plan for us consistent with the Antitrust Commission's directive to maintain a competitive environment within the domestic market and, in 2001, imposed a new obligation on us to justify any modification that we make to our fares.

At the request of the Antitrust Commission, an investigating attorney was appointed to review our self-regulatory fare plan that has been in effect since 1997. The resulting report delivered to us in 2003 by the

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attorney was generally favourable as to our fulfilment of our obligations under the self-regulatory fare plan, and did not find any anticompetitive behaviour. While the attorney recommended that we separate our domestic cargo and domestic passenger businesses, this recommendation is neither binding on the Antitrust Commission nor on us.

On January 30, 2004, the Antitrust Commission imposed a fine of 500 Unidades Tributarias Mensuales (equal to approximately US\$30,000) on each of Lan Airlines and LanExpress for minor breaches of the self-regulatory fare plan to which they are subject. The Company had argued that such breaches were mainly caused by the impossibility of maintaining the fare plan. Other entities also submitted amendment proposals. The Antitrust Court's pronouncement on amendments to the self-regulatory fare plan took place on July 14, 2005 and is now in force and effect.

## **Property**

### *Headquarters*

Our main facilities are located on approximately five acres of land near Arturo Merino Benítez International Airport. The complex includes approximately 150,695 square feet of office space, 32,292 square feet of conference space and training facilities, 9,688 square feet of dining facilities and mock-up cabins used for crew instruction. In 2004, we adapted part of this building to meet our expanding training needs. This process included developing new rooms for technical instruction, in-flight and airport services.

During the fourth quarter of 2003, we moved some of our executive offices into a new building in a more central location in Santiago, where we initially occupied a total of four floors. In the first half of 2005 we added three more floors to accommodate our growth requirements.

### *Maintenance Base*

Our 877,258-square foot maintenance base is located on a site that we own inside the grounds of Arturo Merino Benítez International Airport. This facility contains our aircraft hangar, warehouses, workshops and offices, as well as a 559,720 square foot aircraft parking area capable of accommodating up to 17 short-haul aircraft. We have a five floor, 53,820 square foot office building plus a 10,000 square foot office and workshop space. This facility is certified by several civil aviation authorities, including the United States' FAA. As such, we are permitted to perform maintenance work for third parties at the facility. The FAA periodically inspects the facility to ensure its compliance with FAA standards. In 2005, we finalized the construction of an additional hangar, as well as 75,000 square feet of aircraft parking space, for US\$2.1 million. During 2006 we started a new investment plan at this facility that includes building 64,580 square feet of additional aircraft parking space, a new 15,340 square foot building for offices and maintenance shops, a new 16,680 square foot engine shop and storage facility, and additional warehousing and external work space. The plan also includes upgrading some of the current facilities, increasing parking space and building new access road. We also lease from the DGAC 193,750 square feet of space inside the Arturo Merino Benítez International Airport for operational and service purposes.

### *Miami Facilities*

We occupy a 36.3 acre site at the Miami International Airport that has been leased to us by the airport under a concession agreement. Our facilities include a 48,000 square foot corporate building, a 378,000 square foot cargo warehouse and a 783,000 square foot aircraft parking platform, which were constructed and are now leased to us under a long-term contract by a North American developer. We began using these new facilities in September 2001 for our passenger and cargo offices (with the exception of our reservations and ticket offices). We converted 21,528 square foot of the warehouse into fully furnished offices during 2004.

#### *Other Facilities*

We own a building and 16 acres of land on the west side of Arturo Merino Benítez International Airport that houses a flight-training center. As of May 2006, this facility currently features three full-flight simulators for Boeing 767, Airbus A320 and Boeing 737 aircraft. We rent this flight-training center under a long-term lease to CAE Inc. (a leading Canadian company in the flight training business).

We own a 661,980-square foot warehouse in Santiago, which includes 91,493 square feet of space for offices and other administrative facilities and 45,000 square foot distribution center. We use this facility to support LanCourier's door-to-door cargo transport business.

Terminal de Exportación Internacional, or TEISA, one of our subsidiaries owns a 97,000 square-foot facility that includes a large freezer capacity for the maintenance of perishable exports at optimal conditions located at the Arturo Merino Benítez International Airport.

In 2004, Fast Air Almacenes de Carga S.A., or Fast Air, one of our subsidiaries, began utilizing its new import warehouse and office building at the Arturo Merino Benítez International Airport. This new 172,000 square foot building was developed in conjunction with two other operators.

We have also developed a recreational facility for our employees with Airbus' support. The facility, denominated Parque LAN, is located near the Santiago International airport. Parque LAN includes amenities such as a gymnasium, synthetic fields for multiple uses, and swimming pools.

#### **ITEM 4A. UNRESOLVED STAFF COMMENTS**

None

#### **ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS**

You should read the following discussion of our financial condition and results of operations together with our audited consolidated financial statements and the accompanying notes beginning on page F-3 of this annual report.

Our financial statements have been prepared in accordance with Chilean GAAP, which differs in certain respects from U.S. GAAP. A discussion of the principal differences between Chilean GAAP and U.S. GAAP as they relate to us is described in Note 26 of our audited consolidated financial statements.

#### **Overview**

The principal and most distinctive aspect of our business model is the way in which we integrate our passenger and cargo activities. Our sophisticated service-oriented approach to combining passenger and cargo traffic enables us to better utilize our aircraft, reduce our break-even load factors on passenger flights, and diversify our revenue streams. These benefits have helped us maintain strong profitability and expand our operations during the period between 2003 and 2005.

Approximately 95% of our revenues are generated by our air transport activities. We generate the balance of our operating revenues from airport ground services, aircraft leases, logistics and courier services, on-board sales, tour services, third-party maintenance, ground handling, storage, charter operations, credit card co-branding, CRS services and airline-related security services.

Between 2003 and 2005 our operating environment experienced major changes that had a mixed effect on our results. Specifically, we faced (i) strong passenger demand, (ii) major changes in cargo flows, and (iii) external cost pressures. Passenger demand grew consistently during this period as recovery from

shocks experienced in previous years (such as the September 11, 2001 terrorist attacks and the recession in Argentina in 2002) was compounded by positive economic conditions on our main markets. Cargo demand changed dramatically as the strengthening of local currencies and changes in market conditions for some of our products caused significant changes in both cargo flows to and from Latin America. At the same time, competition on both passenger and cargo routes has grown gradually since mid-2003. However, changes in competitive conditions in specific markets generated opportunities for us to expand. Finally, external factors have also generated significant costs pressures. Fuel prices have risen consistently since 2002 and reached record levels in 2005. Additionally, stronger local currencies have caused costs denominated in these currencies to grow in U.S. dollar terms.

Our results for the period between 2003 and 2005 reflected the actions we have taken in recent years to expand and diversify our revenue base while maintaining an efficient cost base. Between 2003 and 2005 we have aimed to effectively respond to the opportunities and challenges presented by these opportunities. This process included expanding our domestic passenger operations in Peru and supporting the launch of LanArgentina. As a consequence, we have significantly increased our passenger capacity and redeployed our assets in response to specific opportunities. On the cargo business, we have adjusted our routes and our capacity mix to adapt to changing cargo flows. We have also launched initiatives to enhance customer preference and increase efficiency. These initiatives have enabled us to maintain a solid market position and to develop new mechanisms to sustain high levels of profitability despite facing unprecedented fuel prices and start-up losses at LanArgentina. As a consequence, net income amounted to US\$83.6 million in 2003, US\$163.6 million in 2004 and US\$146.6 million in 2005.

#### *Passenger Business*

In general, our passenger revenues are driven by international and country-specific political and economic conditions, competition activity, the attractiveness of the destinations that we serve, and the capacity we allocate among our different routes.

Passenger demand has grown in the last three years driven by positive economic performance in Latin America. Economic growth and improved customer confidence have led to a recovery in both business and leisure traffic to and from Latin America. The appreciation of local currencies versus the U.S. dollars also stimulated international traffic and had a positive impact over Chilean domestic yields in dollar terms. Increased interest in travel into South America from Europe and the United States has been another factor positively impacting overall passenger traffic. As a consequence, passenger volumes in markets such as Chile, Peru, Argentina and Ecuador grew significantly between 2003 and 2005.

Competitive activity on both our domestic and international passenger routes has also varied over the last several years. Between 2003 and 2005, new competition entered the Chilean domestic market and our total domestic traffic and market share were adversely affected. On the contrary, competition weakened significantly in the Peruvian domestic market during this period. On our international routes, competition gradually increased as both incumbent and new competitors expanded their operations.

Overall, market conditions on the passenger business provided us with opportunities to advance on our strategic development plans and expand our operations. We addressed these by taking advantage of our business model, efficient operations, continued customer focus, and flexible capacity management. Additionally, our integrated business model and the efficiency of our operations enabled us to sustain our operations even as we faced weak demand or low pricing. Customer focus has provided with a key tool to address competitive challenges as well as to successfully enter new markets.

We also took advantage of our flexibility to adapt capacity quickly in response to demand shocks or market opportunities. We actively manage our capacity by transferring capacity between routes or adding new aircraft when necessary. This enabled us to rapidly respond by adding capacity in the Peruvian domestic market during 2004 and supporting the launch of LanArgentina's domestic operations in 2005.

These opportunistic actions fit in with our long-term development strategy which is aimed at consolidating LAN as the preferred carrier in the Southern Cone. This plan incorporates development of



domestic, regional and intercontinental routes in the market we serve. Continuous monitoring of demand trends and competitive activity has allowed us to identify opportunities and, as a consequence, additional capacity has also been allocated to operations to the South Pacific and Europe, as well to specific regional routes. We also shifted capacity among our routes in order to better match seasonal patterns in flights to the United States and to other destinations. Further refinements to our itinerary were also implemented in order to improve connectivity between our operations and those of our partners

We have also advanced on our plan to enhance our regional network by selectively adding new destinations and launching new routes. Beginning in 2004, we have been developing an intra-regional hub in Lima. We have launched several routes that enable us to effectively use Lima as a connecting point for passengers traveling between Mexico City, Bogota, Caracas, Guayaquil, Quito, Buenos Aires and Santiago de Chile. We plan to continue growing our operation in Lima by increasing the number of flights we operate on these routes and also by adding new destinations.

Our domestic operations have also grown between 2003 and 2005. The most significant developments have occurred in Peru and Argentina. In Peru, during 2004 we acted to leverage competitive opportunities and significantly increased our market share. In 2005, LanArgentina initiated domestic services in Argentina with service to three cities. By the end of the year, LanArgentina was operating to seven destinations in Argentina.

#### *Cargo Business*

Our cargo business depends on exports from and imports to South America and is, therefore, affected by economic conditions, foreign exchange rates, changes in international trade, the health of particular industries, competition and fuel prices (which we usually pass on to our customers through a cargo fuel surcharge). The relative size of inbound and outbound flows to a particular market or route is a key element in cargo operations as the unidirectional nature of freight flows requires airlines to create routes that combine origin-destination pairs that feature complementary freight flows. During the past three years, changes in these conditions have led to major fluctuations in cargo flows to and from Latin America, therefore requiring continuous route and capacity adjustments.

During the period between 2003 and 2005, the Latin American economic environment underwent significant changes. The appreciation of local currencies such as the Brazilian Real and the Chilean Peso had a significant impact over cargo flows. In the initial stages of this period, local currencies were weak versus the U.S. dollar due to the depreciation they had suffered at the beginning of the current decade. Weak local currencies had led to an export boom and generated a significant imbalance between exports and imports, with the former exceeding the latter. This caused a decline in traffic and created downward pressure on the rates we charge for carrying cargo from the U.S. to Latin America. We faced increased competition during this period, which reduced yields even further and impacted our market share.

Since the second half of 2003, southbound demand recovered due to the improvement in economic conditions in Latin America and the appreciation of currencies such as the Brazilian real and the Chilean Peso. These changes led to improved import traffic into the region during 2004 and helped to balance out import and export traffic flows. Additionally, several cargo airlines reduced their operations in the region in late 2003, leading to a temporary improvement in competitive conditions until several competitors also increased capacity during the second half of 2004.

Continued economic strength and further appreciation of local currencies led to another imbalance in 2005 as imports began to exceed exports. While high oil prices generated upward pressure in yields on both directions, excess demand on southbound routes caused southbound fares to rise more on relative terms. Competition continued to increase during 2005, although high oil prices limited the industry's capacity growth since high levels of efficiency were required to maintain profitability.

We responded to these changing conditions in several ways. We closely monitored demand and redesigned our freighter itineraries accordingly. The flexibility of our freighter operations enabled us to accommodate lower demand and avoid unprofitable routes by combining service to several destinations in the

same trip. For instance we increased the number of trips we performed to and from the Atlantic coast of South America during 2003 and 2004 as exports boomed, but as they decelerated we swiftly added stopovers in export-heavy markets in the Pacific to the northbound trips. We adjusted our capacity through the return of wet-leased freighter aircraft in order to avoid idle capacity during periods of low demand. We also utilized the new Boeing 767 freighters we incorporated in 2005 to replace less efficient wet-leased aircraft. Our expanded route network led to increased diversification and helped us, by allowing us to shift capacity across routes, to partially compensate for reductions in traffic to specific markets. Our cost-effective operations and operating network also gave us a competitive advantage that allowed us to increase market share as other competitors reduced the scale of their operations. Overall, these adjustments enabled us to successfully deal with a complicated environment and ultimately led to an improved market position.

#### *Cost Structure*

Cost controls were critical to maintaining our profitability over the period from 2003 to 2005, especially as we faced increased fuel prices. In absolute terms, the main drivers of our costs are the size of our operations, fuel prices, fleet costs, and exchange rates.

As an airline, we are subject to fluctuations in costs that are outside our control, particularly fuel prices and exchange rates. However, we manage part of our exposure to changes in fuel prices through a fuel-hedging policy and the use of pass-through mechanisms on both the passenger and cargo businesses. Additionally, the incorporation of newer aircraft has enabled us to gradually reduce fuel burn. Personnel expenses are another significant component of our overall costs. Because a significant portion of our labor costs is denominated in pesos, appreciation of the peso against the dollar can result in increased costs in dollar terms and can negatively affect our results. However, this cost pressure is mitigated by the partial natural hedge between our total operating revenues and expenses.

Commissions to travel and cargo agents also compose a significant cost to us. We compete with other airlines over the amount of commission we pay per sale, particularly in connection with special programs and marketing efforts, and to maintain competitive incentives with travel agents. The amount of commissions we pay agents per sale is in most cases adjusted to match industry standards.

Fleet related expenses, basically aircraft rentals and depreciation, are another significant cost. These costs are mainly fixed and can be reduced on a per unit basis by achieving higher daily aircraft utilization rates.

Fuel prices rose consistently between 2003 and 2005 generating significant cost pressure. Average prices between 2003 and 2005 increased 88% and led to approximately US\$301 million additional expenses during the period. As a consequence, higher fuel cost accounted for almost three-fourths of the 22.2% rise in cost per ATK (a key industry metric) between 2003 and 2005. Please refer to “GAAP/Non-GAAP Reconciliation” for further details regarding Cost per ATK.

Fuel price-normalized cost-per ATK increased 5.6% between 2003 and 2005 (using 2003’s average fuel price as a benchmark). The main causes for this were personnel growth, traffic and revenue growth outpacing capacity growth, and a stronger Chilean Peso. Specifically, the expansion of our operations required the anticipated incorporation and training of new personnel. These increases in headcount, combined with the appreciation of the Chilean peso since the second half of 2003, drove increases in wages and benefits and training costs in excess of capacity growth. Additionally, during the second half of 2005 we incurred in additional personnel and training expenses due to the set-up of LanArgentina. Commissions, distribution costs, and passenger services were similarly impacted by revenue and traffic growth.

Despite these challenges, our cost structure remained highly competitive due to careful cost management and more efficient asset utilization. For example, we were able to partially offset these cost increases by negotiating important reductions in aircraft leasing costs and increasing our aircraft utilization rates.

We took advantage of market conditions to renegotiate several aircraft lease contracts. The resulting amendments to the lease agreements led to two main sources of cost reductions: (a) a reduction in the lease rates; and (b) an adjustment in maintenance provisions due to lower required return maintenance conditions and extended redelivery dates of the leased aircrafts. Reduction in aircraft rents as a result of the amendments totaled US\$10 million in 2003, approximately US\$10 million in 2004 and US\$5 million in 2005. As a result of the change in the required return conditions of the leased aircraft upon the expiration of their lease term and the extension of the lease term, we adjusted our maintenance provisions by approximately US\$5 million in 2003. Further negotiations led to a US\$1.9 million adjustment in maintenance provisions for 2004. In 2005 we further reduced our fleet-related expenses by replacing wet-leased aircraft with new Boeing 767-300 freighters.

Higher aircraft utilization has been another source of improved efficiency. In 2003 and 2004, our long-haul passenger and cargo aircraft were used, on average, more than 15 hours per day. Our utilization strategy in 2005 was designed in concert with the addition of new routes to our network, which enabled us to leverage our human and physical assets for increased efficiency.

We have also worked consistently to improve our cost structure. These process has included initiatives such as the modification of short-haul service standards, which were implemented in late 2005 and enabled us to reduce passenger service expenses.

### *Outlook*

Our long-term strategy is aimed at consolidating LAN as the main passenger and cargo airline in South America. We will continue to expand our network by further developing our existing routes, adding new destinations, developing new alliances, and entering new markets. We expect our new brand and a continuous effort to improve service standards to drive increased customer preference; ultimately leading to strong market shares in the markets we serve. Our product and service design is aimed at providing passengers and cargo customers with differentiated offerings that provide valuable solutions to the needs of each of our customer types. We also aim to have products and services that evolve together with changes in technology, market conditions and competitive actions. We plan to maintain a highly competitive cost structure by leveraging our cost-conscious culture, incorporating new technologies and practices, and by identifying and implementing adequate cost-reduction initiatives. We believe a focus on flexibility will enable us to adequately react to changing market conditions. Finally, a healthy financial structure will allow us to effectively fund our growth, enhance our strategic development and reinforce our customer appeal.

For the short term, our results will be mainly determined by the expansion of our current network, the evolution of our market share in our main markets, success in the entrance to new markets, implementation of new efficiency-related programs, and fuel price levels. We plan to increase frequencies on long-haul flights out of Chile, Peru and Ecuador, and eventually add new destinations in the United States and Europe. We also plan to reinforce our regional network through the addition of new frequencies on our current routes and the addition of new destinations. These efforts will be supported by the growth of our newest venture, Lan Argentina, which initiated service in June 2005. We plan to grow domestic operations in Argentina through the increase in frequencies on our current routes and through the addition of new destinations. We also plan to launch international flights out of Argentina to destinations in South and North America. We will also seek to enter into new alliances in both the passenger and cargo business, especially to build up our presence in Asian markets. Competitive activity in key markets increased gradually during 2005, and we expect it to continue doing so in the future. However, we expect to maintain solid market shares based on offering attractive value propositions that combine broad international and domestic networks, a strong customer focus, a competitive cost base. We are also working on increasing efficiency by streamlining our support processes, reducing commercial costs, and by implementing a refined business model on short-haul operations. Further enhancements should arise from economies of scale, especially on Lan Argentina. Our financial performance will also be highly dependent on the evolution of jet fuel prices, which have risen significantly in recent months and have led to a sharp rise in our fuel expenditures. Although we have devised and implemented a number of strategies to mitigate this impact, including financial hedging and the use of fuel surcharges, it is impossible for us to predict if we will be able to fully protect ourselves against an

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increase in fuel costs. Overall, we believe that these initiatives will enable us to successfully respond to growth opportunities, maintain a solid competitive position, and enhance our distinct cost performance.

## Operating Results

The following table sets forth certain income statement data for LAN Airlines.

	In US\$ millions			As a percentage of total revenues			% change	
	2003	2004	2005	2003	2004	2005	04/03	05/04
<b>Operating revenues:</b>								
Passenger	\$ 918.4	\$1,169.0	\$1,460.6	56.0%	55.9%	58.3%	27.3%	24.9%
Cargo	602.0	799.7	910.5	36.7	38.2	36.3	32.8	13.9
Other	118.4	124.2	135.3	7.2	5.9	5.4	4.9	8.9
Total operating revenues	1,638.8	2,092.9	2,506.4	100.0	100.0	100.0	27.7	19.8
<b>Operating expenses:</b>								
Wages and benefits	240.9	292.8	371.6	14.7	14.0	14.8	21.5	26.9
Aircraft fuel	259.6	414.5	642.7	15.8	19.8	25.6	59.7	55.0
Commissions to agents	224.0	291.7	345.4	13.7	13.9	13.8	30.2	18.4
Depreciation and amortization	72.6	77.4	80.5	4.4	3.7	3.2	6.6	3.9
Other rentals and landing fees	258.5	287.8	301.5	15.8	13.8	12.0	11.4	4.8
Passenger services	36.2	45.0	53.2	2.2	2.1	2.1	24.3	18.2
Aircraft rentals	139.1	132.4	148.2	8.5	6.3	5.9	(4.8)	11.9
Aircraft maintenance	97.9	120.8	132.2	6.0	5.8	5.3	23.5	9.4
Other operating expenses	198.3	258.3	289.5	12.1	12.3	11.6	30.3	12.1
Total operating expenses	1,527.1	1,920.8	2,364.7	93.2	91.8	94.3	25.8	23.1
Operating income	111.7	172.1	141.6	6.8	8.2	5.6	54.0	-17.7
<b>Other expense:</b>								
Interest income	6.3	10.8	12.4	0.4	0.5	0.5	72.5	14.7
Interest expense	(39.4)	(36.5)	(39.2)	(2.4)	(1.7)	(1.6)	(7.3)	7.5
Miscellaneous-net	24.1	45.2	58.2	1.5	2.2	2.3	87.2	28.9
Total other expense	(9.0)	19.5	31.5	(0.5)	0.9	1.3	(318.2)	61.1
Income before minority interest	102.8	191.6	173.1	6.3	9.2	6.9	86.5	(9.7)
Minority interest	(0.9)	0.2	1.8	(0.1)	0.0	0.1	(124.4)	727.4
Income before income taxes	101.9	191.8	174.6	6.2	9.2	7.0	88.3	(8.9)
Income taxes	(18.3)	(28.3)	(28.3)	(1.1)	(1.4)	(1.1)	54.3	(0.1)
Net income	\$ 83.6	\$ 163.6	\$ 146.6	5.1%	7.8%	5.8	95.7%	(10.4)%

## 2005 Compared with 2004

### Net Income

Our net income decreased 10.4% from US\$163.6 million in 2004 to US\$146.6 million in 2005. This decrease is mainly due to a 17.7% decrease in operating income as compared to 2004 and 61.1% increase in non-operating income.

Operating income decreased to US\$141.6 million from US\$172.1 million as a 23.1% increase in operating expenses outpaced a 19.8% growth in operating revenues. Revenue growth reflected an improvement in demand in the passenger business, higher import routes into South America in the cargo side, moderate competitive activity and a strong market position, the entrance into new markets, and the expansion of our route network. Operating costs grew due to capacity growth, sales growth, high fuel prices and to the start-up costs related to the launch of LanArgentina.

In 2005 we recorded a US\$31.5 million non-operating gain compared to a US\$19.5 million non-operating gain in 2004. This improvement reflected mainly higher gains on the miscellaneous item (as explained under “Non Operating Income (Expense)”), especially due to increased fuel hedging profits. Finally, income tax expense remained nearly flat at US\$28.3 million in 2005 compared to 2004 as lower taxable income was offset by a higher effective tax rate.

#### *Operating Revenues*

Operating revenues in 2005 totaled US\$2,506.4 million, a 19.8% increase over operating revenues of US\$2,092.9 million in 2004.

Our consolidated passenger revenues grew 24.9% to US\$1,460.6 million in 2005 from US\$1,169.0 million in 2004, due to a 15.6% increase in passenger traffic and a 8.0% improvement in yield (from US¢7.73 to US¢8.35). Passenger traffic (as measured in RPKs) increased primarily because of improved demand in key points of sales, expansion on long-haul and regional routes, consolidation in the Peruvian domestic market and expansion into the Argentine domestic market (both of which are classified as international operations). Passenger yields improved as a result of higher average fares due to improved segmentation, the positive impact of a stronger Chilean peso on fares denominated in Chilean pesos, shorter average trip lengths (shorter trips have higher revenues per passenger-kilometer) and fuel-related fare increases.

Domestic passenger revenues in Chile, which accounted for 20.0% of our total passenger revenues in 2005 and 21.3% in 2004, increased 17.2% to US\$292.2 million in 2005 from US\$249.4 million in 2004. Domestic passenger traffic (as measured in RPKs) decreased 1.9%, while passenger capacity (as measured in ASKs) decreased 2.6%, resulting in a 0.5 percentage point rise in load factor from 66.6% in 2004 to 67.1% in 2005. Domestic passenger yield improved 19.4% from US¢9.95 in 2004 to US¢11.89 in 2005, driven mainly by an average appreciation of 8.7% of the Chilean Peso.

International passenger revenues, which accounted for 80.0% in 2005 and for 78.7% of passenger revenues in 2004, increased 27.0% to US\$1,168.4 million in 2005 from US\$919.7 million in 2004. International passenger traffic (as measured in RPKs) increased 19.1%, while passenger capacity (as measured in ASKs) increased 15.2% in 2005, resulting in a 2.5 percentage point improvement in load factor from 72.6% in 2004 to 75.1% in 2005. Total international passenger yield (based on RPKs) increased 6.7% to US¢7.77 in 2005 from US¢7.29 in 2004, driven by improved segmentation, fuel-price related fare increases and a reduction in average trip lengths (shorter trips have higher revenues per passenger-kilometer).

Cargo revenues grew 13.9%, to US\$910.5 million in 2005 from US\$799.7 million in 2004, as traffic increased 5.9% and yield increased 7.5% to US¢38.06 from US¢35.39. International cargo revenues accounted for nearly 97% of total cargo revenues. Cargo traffic increased mainly due the growth of imports into Latin America and the launch of new routes. Cargo traffic growth decelerated during the year mainly due to the weakening of export traffic out of South America. Cargo yields increased mainly due the application of fuel cost pass-through mechanisms.

Other revenues rose 8.9% to US\$135.3 million in 2005 from US\$124.2 million in 2004 as increased revenues from courier, logistics, warehousing on-board sales, and ground servicing activities were partially offset lower by lower aircraft leasing revenues.

#### *Operating Expenses*

Operating expenses in 2005 totaled US\$2,364.7 million, a 23.1% increase over 2004's operating expenses of US\$1,920.8 million. System capacity, measured in system ATKs, increased 10.6% between 2004 and 2005. Excluding the impact of higher fuel prices, which resulted in US\$187.4 million of additional expenses compared to 2004, operating costs increased 13.4%. Unit costs (measured as operating costs and interest expenses minus other revenues, per ATK) increased 12.0% in 2005. Excluding the impact of higher fuel prices, unit costs grew 2.7%. As a percentage of total operating revenues, consolidated operating expenses increased from 91.8% in 2004 to 94.3% in 2005.

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Wages and benefits expenses grew 26.9% to US\$371.6 million in 2005 from US\$292.8 million in 2004, mainly due to the higher costs in dollar terms caused mainly by the effect of a stronger Chilean peso on wages denominated in Chilean pesos and increases in headcount related to the expansion of our operations.

Aircraft fuel expenses in 2005 totaled US\$642.7 million, a 55.0% increase over 2004's aircraft fuel expenses of US\$414.5 million. Fuel expenses rose due to a 41.2% increase in average fuel prices and a 9.8% increase in fuel consumption. To reflect our operational results more clearly, the gains and losses incurred due to fuel hedging activities are classified as a non-operating item.

Commissions to agents (related to both passenger and cargo sales) increased 18.4% to US\$345.4 million in 2005 from US\$291.7 million in 2004, primarily due to a 20.4% increase in traffic revenues. As a percentage of traffic revenues (passenger and cargo), commissions to agents fell 0.2 percentage points from 14.8% to 14.6%. This decrease is mainly related to lower average passenger commissions and to a rise in the relative weight of passenger revenues compared to cargo revenues (average cargo commissions are higher than passenger commissions). Specifically, the weight of passenger revenues on total revenues increased from 55.9% to 58.3%.

Depreciation and amortization expenses increased 3.9% to US\$80.5 million in 2005 from US\$77.4 million in 2004. Depreciation and amortization increased mainly due to the incorporation of two new Boeing 767 freighters and two new Airbus A319 aircraft. For further information on depreciation policies, refer to "Critical Accounting Policies" below, and Note 2 of our Financial Statements.

Other rental and landing fees increased 4.8% to US\$301.5 million in 2005 from US\$287.8 million in 2004. This increase resulted as the impact of increased operations on both landing fees and ground-handling expenses was partially offset by a reduction in ACMI leases and lower insurance expenses.

Passenger service expenses totaled US\$53.2 million in 2005 and US\$45.0 million in 2004. This represented a 18.2% increase as a 21.1% increase in the number of passengers transported was partially mitigated by efficiency gains due to changes in short-haul standards in the fourth quarter.

Aircraft rental expenses increased 11.9%, to US\$148.2 million in 2005 from US\$132.4 million in 2004 primarily because of the incorporation of additional Boeing 767, Airbus A320 and Boeing 737 aircraft in 2005 and the full year effect of Boeing 767 and Airbus A319 aircraft incorporated in 2004.

Aircraft maintenance expenses increased 9.4%, from US\$120.8 million in 2004 to US\$132.2 million in 2005. Excluding a one-time US\$1.9 million reduction in provisions recorded during the first half of 2004, maintenance expenses rose 7.7% as the effect of capacity growth has been partially offset by efficiency gains arising from the renegotiation of third-party maintenance contracts.

Other operating expenses increased 12.1% to US\$289.5 million in 2005 from US\$258.3 million in 2004. Other operating expenses include sales-related expenses, training, communication, distribution and data processing costs, and banking and non-collectable account expenses. Other operating expenses increased in 2005 due to increases in booking expenses, cost of goods sold on-board, and higher sales-related costs and taxes.

### *Operating Income*

Operating income decreased 17.7%, to US\$141.6 million in 2005 from US\$172.1 million in 2004. Operating margins decreased 2.6 percentage points from 8.2% in 2004 to 5.7% in 2005 as a 23.1% increase in total operating expenses outpaced a 19.8% increase in operating revenues. For the full year, revenues per ATK (passengers and cargo) grew 8.9% (from US¢37.45 to US¢40.80), as costs per ATK increased 12.0% (from US¢34.67 to US¢38.83).

#### *Non-Operating Income (Expense)*

Net non-operating income improved from a US\$19.5 million gain in 2004 to a US\$31.5 million gain in 2005. Interest income increased 14.7% to US\$12.4 million from US\$10.8 million due to higher average cash balances and higher interest rates. Interest expenses increased 7.5% to US\$39.2 million in 2005 from US\$36.5 million in 2004 due to an increase in average debt and higher average interest rates. Miscellaneous gains increased 28.9% to US\$58.2 million in 2005 from US\$45.2 million in 2004 due to an improved fuel hedging gain (to US\$51.5 million in 2005 from US\$46.5 million in 2004) and an improved foreign exchange gain (US\$6.0 million in 2005 compared to US\$2.4 million in 2004).

#### *Income Taxes*

Income tax expense was stable between 2004 and 2005 at US\$28.3 million as the impact of lower pre-tax income was offset by a rise in the average tax rate, from 14.8% in 2004 to 16.2% in 2005. The increase in the average tax rate was caused mainly by the US\$5.7 million one-time reduction in tax expenses recorded in 2004. For more information, see “2004 Compared with 2003” below. Excluding this adjustment, tax expenses decreased 16.3% from US\$33.8 in 2004 to US\$28.3 in 2005, due to lower pre-tax income and a 1.5 point reduction in the average tax rate. For more information, see “—Critical Accounting Policies—Deferred Income Taxes” below and Note 13 to our audited consolidated financial statements.

### **2004 Compared with 2003**

#### *Net Income*

Our net income increased 95.7% from US\$83.6 million in 2003 to US\$163.6 million in 2004. This increase was mainly due to a 54.0% improvement in operating income as compared to 2003 and the reversion from a non-operating loss in 2003 to a non-operating gain in 2004. Operating income improved as a 27.7% increase in operating revenues outpaced a 25.8% growth in operating expenses. Revenue growth reflected an improvement in demand from very low levels in both the passenger and cargo businesses, moderate competitive activity, a strong market position and the expansion of our route network. Operating costs grew in response to capacity growth, sales growth, and high fuel prices. Higher fuel prices, which rose significantly during the year, accounted for approximately US\$108.9 million in additional expenses compared to 2003.

In 2004 we recorded a US\$19.5 million non-operating gain compared to a US\$9.0 million non-operating loss in 2003. This improvement reflected lower net interest expenses and higher gains on the miscellaneous item (as explained under “Non Operating Income (Expense)”) due to fuel hedging profits. Finally, income tax expense increased from US\$18.3 million in 2003 to US\$28.3 million in 2004 primarily because of increased taxable income.

#### *Operating Revenues*

Operating revenues in 2004 totaled US\$2,092.9 million, a 27.7% increase over operating revenues of US\$1,638.8 million in 2003.

Our consolidated passenger revenues grew 27.3% to US\$1,169.0 million in 2004 from US\$918.4 million in 2003, due to a 19.4% increase in passenger traffic and a 6.6% improvement in yield (from US¢7.25 to US¢7.73). Passenger traffic (as measured in RPKs) increased primarily because of improved demand in key points of sales, market share gains in the international routes and the Peruvian domestic market, capacity increases on long-haul operations to the United States, Europe and the South Pacific, and the launch of new regional routes. Passenger yields improved as a result of higher average fares due to improved segmentation, the positive impact of a stronger Chilean peso on fares denominated in Chilean pesos, shorter average trip lengths and fuel-related fare increases.

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Domestic passenger revenues in Chile, which accounted for 21.3% of our total passenger revenues in 2004 and 23.2% in 2003, increased 16.8% to US\$249.4 in 2004 from US\$213.5 million in 2003. Domestic passenger traffic (as measured in RPKs) increased 4.4%, while passenger capacity (as measured in ASKs) decreased 1.6%, resulting in a 6.1 percentage point rise in load factor from 62.8% in 2003 to 66.6% in 2004. Domestic passenger yield improved 11.8% from US¢8.90 in 2003 to US¢9.95 in 2004, driven mainly by the appreciation of the Chilean Peso.

International passenger revenues, which accounted for 78.7% in 2004 and for 76.8% of passenger revenues in 2003, increased 30.5% to US\$919.7 million in 2004 from US\$704.9 million in 2003. International passenger traffic (as measured in RPKs) increased 22.9%, while passenger capacity (as measured in ASKs) increased 19.9%, resulting in a 1.8 percentage point improvement in load factor from 70.8% in 2003 to 72.6% in 2004. Total international passenger yield (based on RPKs) increased 6.3% to US¢7.29 in 2004 from US¢6.86 in 2003, driven by improved segmentation, fuel-price related fare increases and a reduction in average trip lengths (shorter trips have higher revenues per passenger-kilometer).

Cargo revenues grew 32.8%, to US\$799.7 million in 2004 from US\$602.0 million in 2003, as traffic increased 18.2% and yield increased 12.4% to US¢35.39 from US¢31.49. Revenue growth in cargo was driven by increased international revenues, which grew 33.4% to US\$784.5 in 2004 from US\$588.3 in 2003. Cargo traffic increased mainly due to improved market conditions (especially on southbound markets from the United States to South America), market share gains and penetration of previously under-exploited northbound markets. Cargo yields increased mainly due the application of cargo fuel surcharges and an improvement in fares.

Other revenues rose 4.9% to US\$124.2 million in 2004 from US\$118.4 million in 2003 as increased revenues from activities such as aircraft leasing, on-board sales, and ground handling were partially offset lower logistics and third party maintenance revenues.

### *Operating Expenses*

Operating expenses in 2004 totaled US\$1,920.8 million, a 25.8% increase over 2003's operating expenses of US\$1,527.1 million. System capacity increased 15.8% between 2003 and 2004. Excluding the impact of higher fuel prices, which resulted in US\$108.9 million of additional expenses compared to 2003, operating costs increased 18.7%. Unit costs (measured as operating costs and capital expenses minus other revenues, per ATK) increased 9.1% in 2004. Excluding the impact of higher fuel prices, unit costs grew 2.9%. As a percentage of total operating revenues, consolidated operating expenses fell from 93.2% to 91.8%.

Wages and benefits expenses grew 21.5% to US\$292.8 million in 2004 from US\$240.9 million in 2003, mainly due to the higher costs in dollar terms caused by the effect of a stronger Chilean peso on wages denominated in Chilean pesos, increases in headcount related to the expansion of our operations, and higher bonuses.

Aircraft fuel expenses in 2004 totaled US\$414.5 million, a 59.7% increase over 2003's aircraft fuel expenses of US\$259.6 million. Fuel expenses rose due to a 35.6% increase in average fuel prices and a 17.8% increase in fuel consumption. To reflect our operational results more clearly, the gains and losses incurred due to fuel hedging activities are classified as a non-operating item.

Commissions to agents (related to both passenger and cargo sales) increased 30.2% to US\$291.7 million in 2004 from US\$224.0 million in 2003, primarily due to a 29.5% increase in traffic revenues. The remainder of the rise is explained by the faster growth in the cargo business impacting the revenue mix (average cargo commissions are higher than passenger commissions and cargo increased to 40.6% from 39.6% of traffic revenues as well as an increase in average cargo commissions fully offsetting lower passenger commissions (due to lower travel agent commissions and increased direct sales). As a percentage of traffic revenues (passenger and cargo), commissions to agents increased 0.1 percentage points from 14.7% to 14.8%.



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Depreciation and amortization expenses increased 6.6% to US\$77.4 million in 2004 from US\$72.6 million in 2003. Depreciation and amortization increased mainly as new assets were placed into service. For further information on depreciation policies, refer to “Critical Accounting Policies” below, and Note 2 of our Financial Statements.

Other rental and landing fees increased 11.4% to US\$287.8 million in 2004 from US\$258.5 million in 2003. This increase resulted as increased operations led to increases in landing and overflight fees, handling costs, and increased ACMI lease expenses. These increases were partially offset by a reduction in insurance expenses and efficiency gains.

Passenger service expenses totaled US\$45.0 million in 2004 and US\$36.2 million in 2003. This represented a 24.3% increase associated with the 19.4% increase in passenger traffic, a relative increase in premium traffic, and the impact of the stronger Chilean peso on certain peso-denominated materials.

Aircraft rental expenses decreased 4.8%, to US\$132.4 million in 2004 from US\$139.1 million in 2003 primarily because of the effects of the renegotiation of aircraft leases completed in April 2003. This benefit was partially offset by the full year impact of the addition to our fleet of two Airbus A319 aircraft and one Boeing 767-300 aircraft in December 2003 as well as the addition of three Airbus A319 aircraft and four Boeing 767-300 aircraft during 2004.

Aircraft maintenance expenses increased 23.5%, from US\$97.9 million in 2003 to US\$120.8 million in 2004. Aircraft maintenance expenses increased due to increased operations and to the net effect of one-time reductions in expenses in 2003 and 2004. In 2003, we recorded one-time reductions in expenses for a total of US\$5.0 million due to changes in the return conditions of leased aircraft, while in 2004 we recorded a US\$1.9 million one-time reduction in expenses due to additional changes in the return conditions of certain leased aircraft. Excluding these items, maintenance costs grew 19.3%.

Other operating expenses increased 30.3% to US\$258.3 million in 2004 from US\$198.3 million in 2003. Other operating expenses include sales-related expenses, training, communication, distribution and data processing costs, and banking and non-collectable account expenses. Other operating expenses increased in 2004 because of the expansion of operations and sales volumes, and increased training to support both our expansion in Peru and other growth projects.

### *Operating Income*

Operating income increased 54.0%, to US\$172.1 million in 2004 from US\$111.7 million in 2003. Operating margins improved 1.4 percentage points from 6.8% in 2003 to 8.2% in 2004 as a 27.7% increase in total operating revenues outpaced a 25.8% increase in operating expenses. For the full year, revenues per ATK (passengers and cargo) grew 11.8% (from US¢33.50 to US¢37.45), as costs per ATK increased 9.1% (from US¢31.76 to US¢34.67).

### *Non-Operating Income (Expense)*

Net non-operating income improved from a US\$9.0 million loss in 2003 to a US\$19.5 million gain in 2004. Interest income increased 72.5% to US\$10.8 million from US\$6.3 million because of higher cash balances. Interest expenses fell 7.3% to US\$36.5 million in 2004 from US\$39.4 million in 2003 due to lower interest rates and a reduction in average debt. Miscellaneous gains increased 87.2% to US\$45.2 million in 2004 from US\$24.1 million in 2003 as an improved fuel hedging gain (to US\$46.5 million in 2004 from US\$12.3 million in 2003) offset a lower foreign exchange gain (US\$2.4 million in 2004 compared to US\$12.1 million in 2003).

### *Income Taxes*

Income tax expense increased to US\$28.3 million in 2004 from US\$18.3 million in 2003 as the impact of higher taxable income was offset by a US\$5.7 million one-time reduction in expenses related to tax losses generated before December 1999. At that date, Chilean accounting standards changed to the deferred

tax method and according to the rules governing this change, the use of previous tax losses would generate a credit to tax expenses in the period in which they are utilized. Excluding this adjustment, tax expenses increased from US\$18.3 million to US\$33.8 million as higher taxable income was partially offset by a 0.3 point decrease in the effective tax rate to 17.7%. For more information, see “—Critical Accounting Policies—Deferred Income Taxes” below and Note 13 to our audited consolidated financial statements.

### **U.S. Dollar Presentation and Price-Level Adjustments**

LAN Airlines and most of our subsidiaries maintain their accounting records and prepare their financial statements in U.S. dollars. For purposes of preparing the audited consolidated financial statements, we translate monetary assets and liabilities denominated in currencies other than U.S. dollars to U.S. dollars at the exchange rate prevailing at the applicable balance sheet date, and we translate income statement accounts at the exchange rate prevailing on the dates on which the revenues and expenses were received, paid or accrued.

Chilean GAAP requires that financial statements prepared in Chilean pesos recognize the effects of inflation. Accordingly, unless we indicate otherwise, we have restated all financial information of our subsidiaries that maintain their accounts in Chilean pesos to eliminate the distorting effects of changes in inflation on non-monetary assets, liabilities and shareholders’ equity. We have then translated this financial information to U.S. dollars, as described above, for purposes of consolidating it into our audited consolidated financial statements. The general price-level gain or loss we record in the income statement under “Other Income (Expense)” indicates the effect of inflation on our subsidiaries’ net holdings of monetary assets and liabilities during a period of inflation. We consider assets and liabilities “monetary” for purposes of general price-level accounting if their amounts are fixed by contract or otherwise in terms of number of currency units, regardless of changes in specific prices or in the general price level. Examples of “monetary” assets and liabilities include accounts receivable, accounts payable and cash.

#### *Effects of Exchange Rate Fluctuations*

Our functional currency is the U.S. dollar in terms of the pricing of our products, composition of our balance sheet and effects on our results of operations. Most of our revenues (approximately 80% in 2005) are in U.S. dollars or in prices pegged to the U.S. dollar and a substantial portion of our expenses (approximately 73% in 2005) is denominated in dollars or pegged to the U.S. dollar, in particular fuel costs, landing and overflight fees, aircraft rentals, insurance and aircraft components and supplies. Almost all of our liabilities are denominated in U.S. dollars (approximately 94% as of December 31, 2005), including bank loans, air traffic liabilities, and certain amounts payable to our suppliers. As of December 31, 2005, approximately 93% of our assets were denominated in U.S. dollars, principally aircraft, cash and cash equivalents, accounts receivable and other fixed assets. Substantially all of our commitments, including operating leases and purchase commitments for aircraft, are denominated in U.S. dollars.

Although we generally maintain our international passenger fares and cargo prices in U.S. dollars or at prices pegged to the U.S. dollar, we are exposed to foreign exchange losses and gains due to exchange rate fluctuations. We recorded a net foreign exchange gain of US\$12.1 million in 2003, a net foreign exchange gain of US\$2.4 million in 2004, and a net foreign exchange gain of US\$6.0 million in 2005, which are set forth in our income statement under “Other Income (Expense)”. For more information, see Notes 2(e) and 20 to our audited consolidated financial statements. Our exchange gains in 2003, 2004 and 2005 were mainly associated with the appreciation of Latin American currencies, primarily that of the Chilean peso against the U.S. dollar.

### **GAAP/Non-GAAP Reconciliation**

We use “Cost per ATK” and “Cost per ATK excluding fuel price variations” in analyzing operating costs on a per unit basis. “ATKs” (available ton kilometers) measure the number of tons of capacity available for the transportation of revenue load (passengers and/or cargo) multiplied by the kilometers flown. To obtain our unit costs, which are used by our management in the analysis of our results, we divide our “total costs” by

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our total ATKs. “Total costs” are calculated by starting with operating costs as defined under Chilean GAAP and making certain adjustments for interest costs and other revenues. This costs component is further adjusted to obtain “costs per ATKs excluding fuel price variations”, in order to remove the impact of changes in fuel prices for the year. “Cost per ATK” and “Cost per ATK excluding fuel price variations” do not have a standardized meaning, and as such may not be comparable to similarly titled measures provided by other companies. They are not Chilean GAAP-based measures of performance or liquidity. These metrics should not be considered in isolation, or as a substitute for operating costs or as indicators of performance or cash flows as a measure of liquidity. The table below reconciles operating costs as defined by Chilean GAAP to costs used in the calculation of “Cost per ATK” and “Cost per ATK excluding fuel price variations”.

	2003	2004	2005
<b>Cost per ATK</b>			
Operating cost (US\$ thousands)	1,527,083	1,920,845	2,364,717
+ Interest expenses (US\$ thousands)	39,350	36,459	39,191
- Interest income (US\$ thousands)	6,277	10,830	12,426
- Other revenues (US\$ thousands)	118,392	124,240	135,316
ATK operating costs	1,441,764	1,822,234	2,256,166
Divided by systems ATKs (thousands)	4,539,164	5,256,207	5,810,830
= Cost per ATK (US\$ cents)	31.76	34.67	38.83
<b>Cost per ATK excluding fuel price variations</b>			
Cost per ATK (US\$ cents)	1,441,764	1,822,234	2,256,166
- Actual fuel expenses (US\$ thousands)	259,566	414,539	642,696
+ (Gallons consumed) times (previous year’s fuel price)	218,662	310,755	455,265
ATK operating costs excluding fuel price variations	1,400,862	1,718,450	2,068,735
Divided by systems ATKs (thousands)	4,539,164	5,256,207	5,810,830
= Cost per ATK excluding fuel price variations (US\$ cents)	30.86	32.69	35.60

## Seasonality

Our operating revenues are substantially dependent on overall passenger and cargo traffic volume, which is subject to seasonal and other changes in traffic patterns. Our passenger revenues are generally higher in the first and fourth quarters of each year, during the southern hemisphere’s spring and summer, than in the second and third quarters. Since Peru and Ecuador have different seasonal patterns, the expansion into those markets has led to stronger passenger revenues in the second and third quarters, therefore moderating the overall seasonality of our passenger business. Our cargo revenues generally are higher in the fourth quarter, which correspond to the harvest season in the southern hemisphere.

## Critical Accounting Policies

A summary of our significant accounting policies is included in Note 2 to our audited consolidated financial statements, which are included elsewhere in this document. We believe that the consistent application of these policies enables us and our subsidiaries to provide readers of the financial statements with more useful and reliable information about our operating results and financial condition. The preparation of financial statements requires management to make certain estimates and assumptions. The following are the accounting policies that we believe are the most important to the portrayal of our financial condition and results of operations and require our most difficult, subjective or complex judgments.

### *Revenue Recognition*

We recognize passenger revenue and related commissions, if any, when transportation is provided or when the ticket expires unused rather than when a ticket is sold. Unused nonrefundable tickets are considered

expired one year from the date the ticket was sold, or for partially used tickets, one year after the date of the first flight.

The amount of passenger ticket sales not yet recognized as revenue is reflected as air traffic liability. Commissions related to such unearned revenue are shown net of the air traffic liability. Air traffic liability includes estimates of the amount of future refunds and exchanges, net of forfeitures for all unused tickets once the flight date has passed. We perform periodic evaluations of this estimated liability based on historical experiences. Any adjustments, which can be significant, are included in results of operations for the periods in which the evaluations are completed. These adjustments relate primarily to differences between our estimation of certain revenue transactions and the related sales price, as well as refunds, exchange and other items for which final settlement occurs in periods subsequent to the sale of the related tickets at amounts other than the original sales price.

Events and circumstances outside of historical fare sale activity or historical customer travel patterns can result in actual refunds, exchanges or forfeited tickets differing significantly from estimates. We evaluate our estimates periodically. If actual refunds, exchanges or forfeitures fall outside of this range, we review our estimates and assumptions and adjust “Air traffic liability” and “Passenger revenue” as necessary. Our estimation techniques have been consistently applied from year to year; however, as with any estimates, actual refund and exchange activity may vary from estimated amounts. Furthermore, we believe it is unlikely that materially different estimates for future refunds, exchanges and forfeited tickets would be reported.

#### *Property and Equipment*

The key judgments we must make under the property and equipment policy include the estimation of the useful lives of our various asset types, expected residual values, the election to utilize primarily the straight-line method for recording depreciation, management’s judgment regarding appropriate capitalization or expensing of costs related to fixed assets, and our determination that no impairment exists.

Property and equipment are stated at cost and are depreciated by the straight-line method based on the estimated useful lives of the assets. In estimating the lives and expected residual values of our aircraft, we have primarily relied upon actual experience with the same or similar aircraft types and recommendations from the manufacturers of the aircraft we operate. Aircraft estimated useful lives are based on the number of “hours” flown and “cycles” flown (a “cycle” is one take-off and landing). We have made a conversion into years based on both our historical and anticipated future utilization of the aircraft.

We also enter into capital lease agreements relating to aircraft and certain buildings and equipment, which have bargain purchase options at the end of each contract. These assets are not our legal property, because we cannot dispose of them until the purchase option is exercised. These assets are recorded at their fair value on the date of the lease agreement, which is determined by discounting the amounts payable in installments and the purchase option at the interest rate implicit, or explicit, in the contract. The corresponding leasing obligations are presented under long-term liabilities and under the current portion of long-term leasing obligations, net of the corresponding deferred interest.

Property and equipment assets are evaluated for possible impairment, as applicable. Factors that would indicate potential impairment may include, but are not limited to, significant decreases in the market value of long-lived assets, a significant change in the long-lived asset’s physical condition and operating or cash flow losses associated with the use of the long-lived asset. This process requires our estimate of future cash flows generated by each asset or group of assets. For any instance where this evaluation process indicates impairment, the appropriate asset’s carrying values are written down to net realizable value and the amount of the write-down is charged against the results of continuing operations.

Expenditures that substantially improve and/or increase the useful life of facilities, engines and equipment are capitalized. Minor and other unscheduled maintenance costs of aircraft and engines are charged to income as incurred. Costs of major programmed maintenance are accrued based on the use of the aircraft and engines (flying hours). Our estimation of this accrual and the evaluation of whether an expenditure related to property and equipment substantially improves and/or increases the useful life of an asset and is

appropriately capitalized as an addition to the asset's cost basis or is expensed as normal maintenance and repair expense can significantly affect results of operations for a given period, as well as our financial position.

Effective January 2006, the Company decided to change the method of accounting for heavy aircraft and engine maintenance costs related to its owned aircraft. Under the new method, these costs incurred will be capitalized and amortized to the next overhaul while all other minor maintenance costs will be expensed as incurred. The cumulative effect of this change on net income for the year 2006 is an increase in non-operating income of approximately US\$ 40.3 million. This change in accounting principle will be applied prospectively. For further information, see Note 25 to our Audited Financial Statements.

#### *Goodwill*

Management also must exercise judgment in assessing goodwill and negative goodwill for impairment. Goodwill arises from the excess of the purchase price of companies acquired over their net book value. We amortize costs in excess of book value of net assets (and the excess of book value over cost) of our businesses using the straight-line method over a period not to exceed 20 years. This period is based on management's assumption regarding the estimated period of recovery regarding these investments. This assumption takes into consideration various factors including, but not limited to, significant decreases in the market value of the investment, significant changes in legal or regulatory provisions and how these may impact the value of an investment and rates of returns used in calculating operating or cash flow losses associated with the use of our assets. We review the recorded value of our goodwill annually, or sooner if changes in circumstances indicate that the carrying amount may exceed fair value. Recoverability of the carrying value of the asset is determined by comparing net book value, including goodwill, to fair value based on the estimated future net cash flows of the relevant assets.

#### *Derivative Instruments Used For Aircraft Fuel*

We utilize financial derivative instruments to manage the price risk of changing aircraft fuel prices and interest rates. As a portion of our financial derivative instruments are not traded on a market exchange, we estimate their fair values with the assistance of third parties determined by the use of present value methods or standard option value models, with assumptions about commodity prices based on those observed in underlying markets. In addition, as there is not a reliable forward market for jet fuel, we must estimate the future prices of jet fuel in order to measure the effectiveness of the hedging instruments in offsetting changes to those prices. Forward jet fuel prices are estimated by observing similar commodity futures prices (such as crude oil) and adjusted based on variations to those like commodities. As the majority of our fuel hedges settle within 18 months, the variation between estimates and actual prices are recognized in a short period of time.

#### *Deferred Income Taxes*

Effective January 1, 2000, the effects of deferred income taxes arising from temporary differences between the basis of assets and liabilities for tax and financial statement purposes are recorded in accordance with Technical Bulletin No. 60 of the Chilean Institute of Accountants. The effects of deferred income taxes at January 1, 2000, which were not previously recorded, are recognized in income beginning in 2000 as the temporary differences reverse. Under Technical Bulletin No. 60, deferred tax assets are reduced by a valuation allowance if it is more likely than not that some portion or all of the deferred tax asset will not be realized. In making this determination, we consider both positive and negative evidence and make certain assumptions, including projections of taxable income. Changes in these assumptions may have a material impact on results.

## Liquidity and Capital Resources

In recent years, we have been able to meet our working capital and capital expenditure requirements through cash from our operations, proceeds of long-term bank loans, loans from related parties and gains from financial transactions.

Our cash and cash equivalents totaled US\$111.3 million as of December 31, 2005, US\$216.9 million as of December 31, 2004, and US\$157.8 million as of December 31, 2003. Additionally, we held US\$48.0 million as of December 31, 2005; US\$87.8 million as of December 31, 2004; and, US\$61.2 million as of December 31, 2003, in marketable securities not considered to be cash equivalents under Chilean GAAP, which consisted mainly of bonds. In 2003, 2004 and 2005 we were able to invest a portion of our cash balance in such items. We hold significantly all of our cash and cash equivalents in U.S. dollars or U.S. dollar-based instruments. We generally only hold cash and cash equivalents in currencies other than dollars to fulfill short-term obligations that are denominated in local currencies. The decrease in our cash and cash equivalents in 2005 as compared to 2004, was primarily due to a higher amount in pre-delivery payments and acquisitions of property.

At December 31, 2005, we had a working capital deficit (that is, our current liabilities exceeded our current assets) of US\$105.2 million. However, as of December 31, 2004, we had a working capital surplus (that is, our current assets exceeded our current liabilities) of US\$70.3 million. Our working capital deficit in 2005 was mainly related to our air traffic liability and accounts payable. Our air traffic liability refers to tickets that we have sold but which have not yet been used for travel. We recognize the price paid for the ticket as revenue when the tickets are flown. Except in the case of refunds, most of our air traffic liability will not result in cash outflows. Both liabilities arise in our ordinary course of business and, although they fluctuate mainly due to seasonality factors, they are generally proportional to our revenues. We believe this kind of working capital deficit presents no major constraint to our operations or growth strategy.

Net cash inflows from operating activities were US\$276.9 million in 2005, US\$346.8 million in 2004, and US\$235.7 million in 2003, and are derived primarily from providing air passenger and cargo transportation to customers. Operating cash outflows are primarily related to the recurring expenses of operating our airline. Net cash inflows decreased for 2005 mainly due to additional expenses generated by higher jet fuel prices.

Net cash used in investing activities was US\$560.4 million in 2005, US\$152.9 million in 2004, and US\$120.4 million in 2003. Cash capital expenditures were US\$592.4 million in 2005, US\$126.9 million in 2004, and US\$64.8 million in 2003, mainly reflecting the acquisitions of property and equipment. Our capital expenditures for 2005 were composed primarily of cash contributions for pre-delivery deposits related to aircraft that will be incorporated into our fleet between 2006 and 2008, and the acquisition of two Airbus 319 passenger aircraft and two Boeing 767 freighter aircraft. Net cash used in investing activities in 2005 also included US\$39.0 million in investments of financial instruments, consisting primarily of marketable securities. Our capital expenditures for 2004 were composed primarily of cash contributions for pre-delivery deposits related to aircraft that will be incorporated into our fleet in 2005 and 2006, the acquisition of aircraft spare parts and spare engines, and IT hardware and software. Net cash used in investing activities in 2004 also included US\$76.8 million in investments of financial instruments, primarily marketable securities. The capital expenditures for 2003 included the purchase of spare aircraft engines and the acquisition of new office space in Santiago. For more information about current and future capital expenditures, see “Capital Expenditures” below. The difference between net cash used in investing activities and cash capital expenditures during 2004 and 2005 relates mainly to the investment in and sale of financial instruments.

Net cash inflows from financing activities was US\$177.9 million in 2005, compared to net cash used in financing activities of US\$134.8 million in 2004 and US\$117.1 million in 2003. In 2005, our main uses of cash were US\$35.5 million in loan payments and dividends payments for a total of US\$43.5 million. In 2004, our main uses were US\$43.7 million in loan payments and dividends payments for a total of US\$81.6 million. Our main cash uses in 2003 were US\$75.2 million in loan payments and the distribution of US\$49.1 million in dividends. Net cash inflows from financing activities increased mainly due to a higher amount in the loans obtained.

We have generally been able to arrange for short-term loans with local Chilean banks when we have needed to finance working capital expenditures or increase our liquidity. As of December 31, 2005 we held US\$11.7 million in short-term loans with an Argentine financial institution to support the launch of LanArgentina. Should we need access to short-term loans in the future, we believe that we could obtain them based on our well-established relationships with various lenders. As of December 31, 2005, we maintained approximately US\$243.1 million in short-term credit lines with both local and foreign banks, and as of December 31, 2004, we maintained approximately US\$159.0 million in short-term credit lines with both local and foreign banks.

We have contractual obligations and commitments primarily related to the payment of debt, lease arrangements and for the future incorporation of aircraft to our fleet. As of December 31, 2005 we have financed the acquisition of three Boeing 767-300ER passenger aircraft and seven Boeing 767-300F freighters through syndicated loans provided by international financial institutions with the support of partial guarantees issued by the Ex-Im Bank with repayment profiles of either 12 or 15 years. The Ex-Im guarantees support 85% of the net purchase price and are secured with a first priority mortgage on the aircraft in favor of a security trustee on behalf of Ex-Im Bank. The documentation for each loan follows standard market forms for this type of financing, including standard events of default. We have financed the remaining 15% of the net purchase price with commercial loans. Our Ex-Im supported financings amortize on a quarterly basis, are denominated in U.S. dollars and while some have fixed interest rates, others bear interest at a floating rate linked to U.S. dollar LIBOR. Through the use of interest rate swaps, we have effectively converted almost all of our floating rate debt under these loans into fixed rate debt. During 2004, LAN sold its stakes in the entities borrowing some of these loans and they were therefore reclassified as financial leases. At December 31, 2005, the total amount outstanding under our Ex-Im Bank-supported financings totaled approximately US\$589 million. We have also arranged additional syndicated loans to support the acquisition of 11 Boeing 767-300ER and two Boeing 767-300F aircraft to be delivered between 2006 and 2008. We plan to finance 85% of the net purchase price of these aircraft with Ex-Im Bank-supported loans and to use internal funds to pay for the remaining 15% of the net purchase price (except for the first delivery of 2006, which occurred in May and for which the aforementioned 15% was funded through a commercial loan). See “Quantitative and Qualitative Disclosures About Market Risk—Risk of Fluctuations in Interest Rates” under Item 11 for more information.

In 2000, in order to finance our Airbus aircraft, we entered into a US\$1.3 billion umbrella credit facility with a syndicate of international financial institutions under which we borrow in the form of separate loans in connection with the specific financing requirements of each Airbus aircraft (including pre-delivery and long-term financings). This umbrella facility provides for guarantees from the English, French and German Export Credit Agencies and contains customary terms for the industry, including standard events of default. Loans under the facility are denominated in U.S. dollars and bear interest at floating rates linked to LIBOR. The majority of these loans have been converted into fixed rate loans through interest rate swaps. As of December 31, 2005, we had drawn approximately US\$937 million under the facility. Some of the loans drawn under the facility mature 12 years from the delivery date of the corresponding aircraft and others have longer repayment periods, maturing 18 years after the initial drawdown. In connection with the facility, we have incorporated Airbus aircraft into our fleet through operating leases, financial leases and tax leases. This financing facility covered the aircraft that we were scheduled to acquire through December 31, 2006 pursuant to the purchase agreements signed with Airbus in 1998 and 1999. However, we terminated this facility in late 2005 as we decided to negotiate a new facility to support the 32 Airbus A320-family aircraft we are to receive between 2006 and 2008 pursuant to our previous orders and the new purchase agreement we signed in 2005. This new facility was arranged in early 2006 and is expected to be provided with guarantees from the English, French and German Export Credit Agencies for 85% of the net purchase price of each aircraft. The remaining 15% of the net purchase price will be funded internally.

Our total long-term debt (including capital leases) at December 31, 2005 was US\$770.1 million compared to US\$582.4 million in 2004. The increase in long-term debt during 2005 relates mainly to the incorporation of debt-financed fixed assets. We have minimum lease payment obligations primarily associated with our aircraft leases. As of December 31, 2005, we had 45 aircraft under operating leases, and we had minimum lease payment obligations of US\$856.0 million compared to US\$874.3 million as of December 31, 2004. Minimum lease payment obligations decreased as the effect of the incorporation of new aircraft under lease agreements and the extension of several lease contracts was offset by the consumption of

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one year of lease-payments. At December 31, 2005, we also had purchase obligations for 20 Airbus A318s, eight Airbus A319s, four Airbus A320s, two Airbus A340 aircraft, nine Boeing 767-300ER and one Boeing 767-300F aircraft amounting to a combined total of approximately US\$2,019.5 million. As of May 31, 2006, we had taken delivery of one of the Boeing 767-300ER and had ordered three additional Boeing 767-300ER aircraft.

The average interest rate of our long-term debt was 5.1% as of December 31, 2005. Approximately 87.5% of our debt effectively accrues interest at a fixed rate (either through a stated fixed interest rate or through our use of interest rate swap agreements) or is subject to interest rate caps. However, as of December 31, 2005 floating interest rates under the portion of our long-term debt that is subject to the interest rate caps had not reached their capped levels. Giving effect to the caps, as of December 31, 2005 the highest possible average interest rate that the 87.5% of our long-term debt could be subject to was 5.1%.

We have a BBB- credit rating from Fitch. This investment grade credit rating was affirmed in March 2006 and Fitch has assigned it a positive outlook.

The following table sets forth our material expected obligations and commitments as of December 31, 2005.

	Payments due by period, as of December 31, 2005						
	Total	2006	2007	2008	2009	2010	Thereafter
Principal debt payments	\$ 575.1	\$ 53.1	\$ 58.8	\$ 53.0	\$ 54.5	\$ 57.2	\$ 298.5
Interest debt payments	239.1	41.1	37.8	33.6	29.1	24.5	73.0
Capital leases <sup>(1)</sup>	221.9	40.1	41.8	43.0	43.8	33.5	19.7
Operating leases <sup>(2)</sup>	856.0	150.6	139.1	120.1	101.0	91.3	253.9
Purchase obligations	2,019.5	662.4	433.2	923.9	—	—	—
Total	<u>\$3,911.6</u>	<u>\$947.3</u>	<u>\$710.7</u>	<u>\$1,173.6</u>	<u>\$228.4</u>	<u>\$206.5</u>	<u>\$ 645.1</u>

<sup>(1)</sup> Includes interests

<sup>(2)</sup> Includes aircraft leases and other non-cancelable leases

## Capital Expenditures

Over the last three years our cash capital expenditures were US\$64.8 million in 2003, and US\$126.9 million in 2004, and US\$592.4 million in 2005 mainly reflecting our acquisition of aircraft and aircraft-related equipment, IT equipment and support infrastructure, and the funding of pre-delivery deposits.

The following chart sets forth our estimate, as of December 31, 2005, of our future capital expenditures for 2006, 2007 and 2008:

	Expenditures by year, as of December 31, 2005		
	(in US\$ millions)		
	2006	2007	2008
Expenditures on aircraft	\$ 662	\$ 433	\$ 924
Other expenditures <sup>(1)</sup>	140	115	125
Total	<u>\$ 802</u>	<u>\$ 548</u>	<u>\$ 1,049</u>

<sup>(1)</sup> Includes expenditures on spare engines and parts, information technology and other expenditures.



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The addition of three additional Boeing 767-300 passenger aircraft to our order book (for delivery in 2007 and 2008) together with the reprogrammed delivery of two A320 for 2007, originally planned for 2008, caused our expected capital expenditures on aircraft to increase compared to the amounts stated on the previous table. As of May 31, 2006, our planned capital expenditures amount US\$802 million for 2006, US\$702 million for 2007 and US\$1,134 million for 2008.

We expect that cash generated from operations, short-term credit-lines and the long-term syndicated loans already negotiated with various banks will be sufficient to meet our cash requirements in the foreseeable future, although events that materially affect our operating results could also have a negative impact on our liquidity.

### **Credit Card Receivables Securitization**

We have raised a total of US\$100.0 million through two similar transactions involving the private placement of certificates backed by our credit card receivables. In these transactions, we sold our right to receive certain present and future U.S. dollar payment obligations, referred to as future credit card receivables, arising from the purchase of passenger tickets and related services in the United States through American Express, Diner's Club, Discover, Visa and MasterCard to Pelican Finance Ltd. ("Pelican"). In the first transaction, completed in March 1999, we sold US\$60.0 million of our future credit card receivables to Pelican which then issued notes to a United States trust, backed by payments received on these payment obligations, which in turn issued trust certificates, backed by payments received on the notes, to investors. This transaction had a term of seven years and our sale of these receivables authorized Pelican to collect payments on them until March 2006. Final payment for this transaction was due in June 2006. In August 2002, we entered into a similar sale of future credit card receivables to Pelican for an additional US\$40.0 million. This transaction had a term of seven years, with a four year grace period on principal payments. Our sale of these receivables authorizes Pelican to collect payments on them until the earlier of the date the notes issued by Pelican are fully redeemed and August 2009.

### **Off-Balance Sheet Arrangements**

We do not have any off-balance sheet arrangement including any transactions, agreements or other contractual arrangements involving an unconsolidated entity under which we have:

- made guarantees;
- a retained or a contingent interest in transferred assets;
- an obligation under derivative instruments classified as equity; or
- any obligation arising out of a material variable interest in an unconsolidated entity that provides financing, liquidity, market risk or credit risk support to us, or that engages in leasing, hedging or research and development arrangements with us.

We record payments made under operating leases as expenses, and none of our operating lease obligations are reflected on our balance sheet. The decision to finance aircraft through operating leases rather than through debt was based on an analysis of the cash flows and tax consequences of each option and a consideration of our liquidity requirements. We are responsible for all maintenance, insurance and other costs associated with operating these aircraft; however, we have not made any residual value or similar guarantees to our lessors. We have also made certain guarantees and indemnities to other unrelated parties that are not reflected on our balance sheet, although we believe these will not have a significant impact on our results of operations or financial condition. We have no other off-balance sheet arrangements. See Notes 1 and 21 to our audited consolidated financial statements for a more detailed discussion of contingencies, including guarantees.

### **Differences between Chilean GAAP and U.S. GAAP**

Our audited consolidated financial statements are prepared in accordance with Chilean GAAP, which differs in certain significant respects from U.S. GAAP. See Note 26 to our audited consolidated financial statements for a discussion of these differences and their effect on our results of operations.

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Our net income determined under U.S. GAAP would have been US\$155.0 million in 2005, US\$160.7 million in 2004, and US\$88.8 million in 2003 as compared with net income under Chilean GAAP of US\$146.6 million in 2005, US\$163.6 million in 2004, and US\$83.6 million in 2003. These differences could be material to the financial information presented in accordance with Chilean GAAP. The main differences affecting the determination of net income include the different treatment of expenses for amortization of goodwill, adjustments for differences in the deferred tax provision as calculated under U.S. GAAP, the ineffectiveness of certain derivative instruments resulting in additional adjustments under Chilean GAAP; and, certain expenses related to derivative instruments that do not qualify as hedging relationships under U.S. GAAP.

Shareholders' equity determined under U.S. GAAP would have been US\$493.3 million at December 31, 2005; US\$415.6 million at December 31, 2004; and, US\$323.5 million at December 31, 2003 as compared with shareholders' equity under Chilean GAAP of US\$502.7 million at December 31, 2005; US\$434.6 million at December 31, 2004; and, US\$352.6 million at December 31, 2003 principally due to differences in purchase accounting adjustments, adjustments for the provision for deferred income taxes, and goodwill amortization.

## **ITEM 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES**

### **Directors and Senior Management**

The administration of LAN Airlines is conducted by its board of directors which, in accordance with LAN Airlines' bylaws, consists of nine directors who are elected every two years for two-year terms at annual regular shareholders' meetings, and may be re-elected. The board of directors may appoint replacements to fill any vacancies that occur during periods between elections. Scheduled meetings of the board of directors are held once a month and extraordinary board of directors' meetings are called when summoned by the chairman of the board of directors and two other directors, or when requested by a majority of the directors.

The current board of directors was elected at the annual shareholders' meeting held in April 2006. Its term expires in April 2008. The following are LAN Airlines' directors and senior management as of May 31, 2006:

<b>Directors</b>	<b>Position</b>
Jorge Awad Mehech <sup>(1)</sup>	Director / Chairman
Darío Calderón González	Director
José Cox Donoso	Director
Juan José Cueto Plaza <sup>(2)</sup>	Director
Juan Cueto Sierra <sup>(2)</sup>	Director
Ramón Eblen Kadis <sup>(3)</sup>	Director
Bernardo Fontaine Talavera	Director
Andrés Navarro Haeussler	Director
Sebastián Piñera Echenique <sup>(4)</sup>	Director

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Senior Management	Position
Enrique Cueto Plaza <sup>(2)</sup>	Chief Executive Officer
Ignacio Cueto Plaza <sup>(2)</sup>	President and Chief Operating Officer
Luis Ernesto Videla Berguecio	Senior Vice President, Strategic Development
Alejandro de la Fuente Goic	Chief Financial Officer
Armando Valdivieso Montes	Chief Executive Officer-Passenger
Cristián Ureta Larraín	Chief Executive Officer-Cargo
Carlos Prado Cánepa	Senior Vice President, Corporate Investment
Marco Jofré Marín	Senior Vice President, Operations, Engineering and Maintenance
Enrique Elsaca Hirmas	Senior Vice President, Strategic Planning
Emilio del Real Sota	Senior Vice President, Human Resources

- <sup>(1)</sup> Mr. Jorge Awad Mehech was re-elected chairman of the board of directors in May 2006.
- <sup>(2)</sup> Messrs. Ignacio, Juan José and Enrique Cueto Plaza are brothers, and Mr. Juan Cueto Sierra is their father. All four are members of the Cueto Group (as defined in “Item 7”), one of the Controlling Shareholders.
- <sup>(3)</sup> Mr. Ramón Eblen Kadis is a member of the Eblen Group (as defined in “Item 7”), a major shareholder.
- <sup>(4)</sup> Mr. Sebastian Piñera Echenique is a member of the Piñera Group (as defined in “Item 7”), one of the Controlling Shareholders.

## Biographical Information

Set forth below are brief biographical descriptions of LAN Airlines’ directors and senior management.

### Directors

*Mr. Jorge Awad Mehech*, 60 years old, has served as chairman and member of LAN Airlines’ board of directors since July 2001. Mr. Awad had previously served as chairman of our board of directors from 1994 to October 2000. Mr. Awad’s current term as chairman ends on the date of the next annual shareholders’ meeting. He held the position of Senior Vice President of Fast Air from 1979 to 1993. Mr. Awad currently serves on the boards of directors of several other Chilean companies, including Banco de Chile, Envases del Pacifico S.A., Edyce S.A. and Universidad de Talca. He is also a board member of ICARE (Instituto Chileno de Administracion Racional de Empresas), a Chilean organization seeking to promote private enterprise. As of May 31, 2006, according to shareholder registration data in Chile, Mr. Awad shared in the beneficial ownership of LAN Airlines, through Inversiones y Asesorías Fabiola S.A., of 189,943 common shares (0.1% of LAN Airlines’ outstanding shares).

*Mr. Darío Calderón González*, 59 years old, has served on LAN Airlines’ board of directors since 1994. Mr. Calderón’s term as a director ends on the date of the next annual shareholders’ meeting. Mr. Calderón has been a partner in Calderón y Cía., a Chilean law firm, since 1970. Mr. Calderón currently serves the board of directors of other Chilean companies, including Integramedica S.A., Imprenta A Molina Flores S.A., Inmobiliaria Cumbres S.A., and Calzados Gino S.A.

*Mr. José Cox Donoso*, 51 years old, has served on LAN Airlines’ board of directors from April 1994 to June 1995 and from September 1995 to the present. Mr. Cox’s term as a director ends on the date of the next annual shareholders’ meeting. Mr. Cox has also served as chairman of the board of directors of LAN Airlines Cargo since September 1995. In addition, Mr. Cox has served on the board of directors of CMB-Prime Asset Managing Corp. since September 1993. Mr. Cox is also chairman of the Chilean Electronic Stock Exchange. As of May 31, 2006, according to shareholder registration data in Chile, Mr. Cox shared in the beneficial ownership of LAN Airlines, through Inversiones Aéreas CGP Dos S.A., 2,654,324 common shares of LAN Airlines (0.8% of LAN Airlines’ outstanding shares).

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*Mr. Juan José Cueto Plaza*, 46 years old, has served on LAN Airlines' board of directors since 1994. Mr. Cueto's term as a director ends on the date of the next annual shareholders' meeting. Mr. Cueto currently serves as Executive Vice President of Inversiones Costa Verde S.A., a position he has held since 1990, and on the boards of directors of Forestal Copihue S.A. and Minera Michilla S.A. Mr. Cueto is the son of Mr. Juan Cueto Sierra, a director of LAN Airlines, and the brother of Messrs. Enrique and Ignacio Cueto Plaza, Chief Executive Officer and Chief Operating Officer of LAN Airlines, respectively. Mr. Cueto is a member of the Cueto Group (a group of Controlling Shareholders of LAN Airlines one of Lan Airlines' Controlling Shareholders). As of May 31, 2006, Mr. Cueto shared in the beneficial ownership of 86,133,567 common shares of LAN Airlines (27.0% of LAN Airlines' outstanding shares) held by the Cueto Group. For more information see "Item 7. Controlling Shareholders and Related Party Transactions".

*Mr. Juan Cueto Sierra*, 76 years old, was one of the founders of Fast Air in 1978 and has served on LAN Airlines' board of directors since 1998. Mr. Cueto's term as a director ends on the date of the next annual shareholders' meeting. Mr. Cueto has wide experience in a range of business activities. Mr. Cueto is the father of Messrs. Juan José, Enrique and Ignacio Cueto Plaza, Director, Chief Executive Officer and Chief Executive Officer-Passenger Business of LAN Airlines, respectively.

*Mr. Ramón Eblen Kadis*, 61 years old, has served on LAN Airlines' board of directors since June 1994. Mr. Eblen's term as a director ends on the date of the next annual shareholders' meeting. Mr. Eblen has served as President of Comercial Los Lagos Ltda., Inversiones Santa Blanca S.A., and TJC Chile S.A.. Mr. Eblen is a member of the Eblen Group (a major shareholder of LAN Airlines). As of May 31, 2006, Mr. Eblen shared in the beneficial ownership of 31,778,049 common shares of LAN Airlines (approximately 10.0% of LAN Airlines' outstanding shares) held by the Eblen Group. For more information see "Item 7. Controlling Shareholders and Related Party Transactions".

*Mr. Andrés Navarro Haeussler*, 57 years old, joined LAN Airlines' board of directors in April 2004. Mr. Navarro's term as a director ends on the date of the next annual shareholders' meeting. Mr. Navarro holds a Civil Engineering degree from Universidad Católica de Chile. He is the president and founder of Sonda S.A., a leading IT services provider in Latin America, which has operations in eleven Latin American countries, including Mexico, Brazil, Argentina, Chile and Colombia. He is also the Chairman of the Board of Clínica Las Condes and of Inmobiliaria y Constructora Aconcagua S.A. and member of the board of Fundación Teleton, a non-profit organization.

*Mr. Sebastián Piñera Echenique*, 56 years old, joined LAN Airlines's board of directors in February 1999. Mr. Piñera served as chairman of LAN Airlines's board of directors from October 2000 to April 2001. Mr. Piñera resigned as member of LAN Airlines's board of directors in May 2005 in order to run for the Presidency of Chile. Mr. Piñera was elected to the board in April 2006. He has been a member of the Chilean senate, and also he served as President and General Manager of Citicorp Chile from 1980 to 1987. Mr. Piñera currently serves as director of the boards of directors of Quintec and Colo Colo. In addition, from May 2001 to March 2004, Mr. Piñera served as President of Renovación Nacional, a Chilean political party. Mr. Piñera holds a Ph.D. in Economics from Harvard University. As of May 31, 2006, according to shareholder registration data in Chile, Mr. Piñera shared in the beneficial ownership, through Axxion S.A. and Inversiones Santa Cecilia S.A., of 86,245,794 common shares of LAN Airlines (27.0% of LAN Airlines' outstanding shares). For more information see "Item 7. Controlling Shareholders and Related Party Transactions".

*Bernardo Fontaine Talavera*, 41 years old, has served on LAN Airlines' board of directors since April 2005. Mr. Fontaine's term ends on the date of the next annual shareholders' meeting. Mr. Fontaine has held various responsibilities on the financial services branch of Falabella, a major Chilean retailer, and served as Executive Director of CMR Falabella and Vice-Chairman of the Board of Banco Falabella. Mr. Fontaine also served as head of the M&A Corporate Finance division of Citicorp-Citibank Chile. Mr. Fontaine currently serves on the boards of Almagro S.A., Loginsa S.A. and Polygon S.A.. He is also the general manager of Tres Mares S.A., which owns 15,090,598 shares of Lan Airlines S.A. (4.7% of Lan Airlines' outstanding shares).

### Senior Management

*Mr. Enrique Cueto Plaza*, 47 years old, is LAN Airlines' Chief Executive Officer, and has held this position since 1994. From 1993 to 1994, Mr. Cueto served on LAN Airlines' board of directors. From 1983 to 1993, Mr. Cueto was Chief Executive Officer of Fast Air, a Chilean Cargo airline. Mr. Cueto has in-depth knowledge of passenger and cargo airline management, both in commercial and operational aspects, gained during his eighteen years in the airline industry. -. Mr. Cueto is an active member of the oneworld Alliance Governing Board, the IATA (International Air Transport Association) Board of Governors. He is also member of the Board of the Federation of Chilean Industry (SOFOFA) and of the Board of the Endeavor foundation, an organization dedicated to the promotion of entrepreneurship in Chile. Mr. Cueto is the son of Mr. Juan Cueto Sierra, a member of the board of LAN Airlines, and the brother of Messrs. Juan José and Ignacio Cueto Plaza, member of the board and President and Chief Operating Officer of LAN Airlines, respectively. Mr. Cueto is also a member of the Cueto Group (one of Lan Airlines' Controlling Shareholders). As of May 31, 2006, Mr. Cueto shared in the beneficial ownership of 86,133,567 common shares of LAN Airlines (27.0% of LAN Airlines' outstanding shares) held by the Cueto Group. For more information see "Item 7. Controlling Shareholders and Related Party Transactions".

*Mr. Ignacio Cueto Plaza*, 42 years old, is LAN Airlines' President and Chief Operating Officer. Until being promoted to his current position in 2005, Mr. Cueto served as Chief Executive Officer-Passenger Business, Passenger, a position he assumed in 1999. Mr. Cueto served on the board of directors of LAN Airlines and Ladeco from 1995 to 1997 and from 1994 to 1997, respectively. In addition, Mr. Cueto served as Chief Executive Officer of Fast Air from 1993 to 1995 and as President of the LanCargo Group from 1995 to 1998. Between 1985 and 1993, Mr. Cueto held several positions at Fast Air, including Service Manager for the Miami sales office, Director of Sales for Chile and Vice President of Sales and Marketing. Mr. Cueto is the son of Mr. Juan Cueto Sierra, Director of LAN Airlines, and the brother of Messrs. Juan José and Enrique Cueto Plaza, Director and Chief Executive Officer of LAN Airlines, respectively. Mr. Cueto is also a member of the Cueto Group (one of Lan Airlines' Controlling Shareholders). As of May 31, 2006, Mr. Cueto shared in the beneficial ownership of 86,133,567 common shares of LAN Airlines (27.0% of LAN Airlines' outstanding shares) held by the Cueto Group. For more information see "Item 7. Controlling Shareholders and Related Party Transactions".

*Mr. Luis Ernesto Videla Berguecio*, 45 years old, is LAN Airlines' Senior Vice President Strategic Development, a position he assumed in 2005. Mr. Videla was LAN Airline's Chief Operating Officer between 1996 and 2005. Prior to that, Mr. Videla served as LAN Airlines' Vice President of Marketing and Sales from 1995 to 1996, and as LAN Airlines' Vice President of Planning and Development from 1994 to 1995. From 1989 until 1994, Mr. Videla held the position of Vice President, Planning at Fast Air. Before 1989, Mr. Videla worked at Banco de Crédito e Inversiones. As of May 31, 2006, Mr. Videla owned 44,704 common shares of LAN Airlines (0.02% of LAN Airlines' outstanding shares).

*Mr. Alejandro de la Fuente Goic*, 47 years old, is LAN Airlines' Chief Financial Officer, and has held this position since October 1995. Mr. de la Fuente joined LAN Airlines in April 1995. Prior to joining LAN Airlines, Mr. de la Fuente served as Director of Management and Finance of Chiquita Frupac Ltd., a subsidiary of Chiquita Brands Inc., beginning in 1992. As of May 31, 2006, Mr. de la Fuente owned 51,175 common shares of LAN Airlines (0.02% of LAN Airlines' outstanding shares).

*Mr. Armando Valdivieso Montes*, 43 years old, is LAN Airlines' Chief Executive Officer-Passenger, a position he assumed in 2006. Between 1997 and 2005 he served as Chief Executive Officer-Cargo Business. From 1994 to 1997, Mr. Valdivieso was President of Fast Air. From 1991 to 1994, Mr. Valdivieso served as Vice President, North America of Fast Air Miami. As of May 31, 2006, according to shareholder registration data in Chile, Mr. Valdivieso owned 59,704 common shares of LAN Airlines (0.02% of LAN Airlines' outstanding shares).

*Mr. Cristian Ureta*, 43 years old, is LAN Airlines' Chief Executive Officer-Cargo, a position he assumed in 2005. Mr. Ureta has a Engineering degree from Pontificia Universidad Catolica and a Special Executive Program in Stanford University Ca. Between 2002 and 2005 Mr. Ureta served as Production Vice President for LAN Cargo. Between 1998 and 2002 he was LAN Cargo's Planning and Development Vice

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President. Prior to that, Mr. Ureta served as General Director and Commercial Director at MAS Air, and as Service Manager for Fast Air.

*Mr. Carlos Prado Cánepa*, 56 years old, is LAN Airlines' Senior Vice President, Corporate Investments, and has held this position since July 1998. From 1992 to 1998, Mr. Prado served as LAN Airlines' Senior Vice President, Technical. From 1986 to 1992, he served as Chief Executive Officer of Exim Air S.A. From 1982 to 1986, Mr. Prado served as our Vice President, Cargo, and from 1981 to 1982 as our Fuel Manager.

*Mr. Marco Jofré Marín*, 42 years old, is LAN Airlines' Senior Vice President, Operations and Engineering. Mr. Jofré has been responsible for Operations since August 1998 and for Engineering and Maintenance since May 2002. From 1997 to 1998, Mr. Jofré served as Executive Vice President of Fast Air, from 1992 to 1997 as Planning Director of Fast Air and from 1990 to 1992 as Vice President Services, North America of Fast Air Miami. Currently, Mr. Jofré also serves as a consultant to the Academy of Aeronautical Sciences and on the boards of directors of Flight Training Center-Chile. As of May 31, 2006, according to shareholder registration data in Chile, Mr. Jofré owned 25,588 common shares of LAN Airlines (0.01% of LAN Airlines' outstanding shares).

*Mr. Enrique Elsaca Hirmas*, 38 years old, is LAN Airlines' Senior Vice President, Strategic Planning, a position he assumed in July 2004. Mr. Elsaca has a degree in industrial engineering from Pontificia Universidad Católica de Chile, as well as a Master in Business Administration from Massachusetts Institute of Technology. Prior to joining LAN Airlines, Mr. Elsaca served as Real Estate and Development Manager of Cencosud, Chile's second largest retail group. From 1997 to 1999, Mr. Elsaca worked at Booz Allen & Hamilton in Latin America, and from 1991 to 1995, Mr. Elsaca held various positions in Esso Chile, a subsidiary of Exxon.

*Mr. Emilio del Real Sota*, 41 years old, is LAN Airlines' Senior Vice President Human Resources, a position he assumed in August 2005. Mr. del Real has a Psychology degree from Universidad Gabriela Mistral. Between 2003 and 2005, Mr. del Real was the Human Resource Manager of DYS, a Chilean retail company. Between 1997 and 2003 Mr. del Real served in various positions in Unilever, including Human Resource Manager for Chile, and Training and Recruitment Manager and Management Development Manager for Latin America.

## **Compensation**

For the year ended December 31, 2005, the aggregate amount of compensation we paid to all executives and senior managers was US\$40.0 million, which included US\$4.3 million in bonuses. Our variable compensation plan is based on our corporate profits, and team and individual performance.

Under Chilean law, LAN Airlines must disclose in its annual report details of all compensation paid to its directors during the relevant fiscal year, including any amounts that they received from LAN Airlines for functions or employment other than serving as a member of the board of directors, including amounts received as per diem stipends, bonuses and, generally, all other payments. Additionally, pursuant to regulations of the *Superintendencia de Valores y Seguros*, or the SVS, the annual report must also include the total compensation and severance payments received by managers and principal executives, and the terms of and the manner in which board members and executive officers participate in any stock option plans.

LAN Airlines' directors are paid 24 UF per meeting (56 UF for the chairman of the board). LAN Airlines also provides certain benefits to its directors and executive officers, such as free and discounted airline tickets and health insurance. We do not have contracts with any of our directors to provide benefits upon termination of employment.

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As set forth in further detail in the following table, in 2005, the members of our board of directors currently in office received fees and salaries in the aggregate amount of US\$108,096.

<b>Board Members</b>	<b>Fees (US\$)<sup>(1)</sup></b>
Jorge Awad Mehech	US\$ 29,558
Ramón Eblen Kadis	17,448
José Cox Donoso	15,908
Darío Calderón González	9,082
Andrés Navarro Haeussler	9,082
Juan José Cueto Plaza	8,251
Juan Cueto Sierra	6,739
Bernardo Fontaine Talavera	6,237
Sebastián Piñera Echenique	3,649
Boris Hirmas Said	2,141
<b>Total</b>	<b>US\$ 108,096</b>

<sup>(1)</sup> Includes fees paid to members of the board of directors' committee, as described below.

As required by Chilean law, LAN Airlines makes obligatory contributions to the privatized pension fund system on behalf of its senior managers and executives, but it does not maintain any separate program to provide pension, retirement or similar benefits to these or any other employees.

### **Board of Directors' Committee and Audit Committee**

Pursuant to Chilean Corporation Law, as amended by Law No. 19705, LAN Airlines must have a board of directors' committee composed of no less than three board members. LAN Airlines has established a three-person committee of its board of directors, which, among other duties, is responsible for:

- examining the reports of LAN Airlines' external auditors, the balance sheets and other financial statements submitted by LAN Airlines' administrators to the shareholders, and issuing an opinion with respect thereto prior to their presentation to the shareholders for their approval;
- proposing external auditors and rating agencies to the board of directors;
- evaluating and proposing external auditors and rating agencies;
- reviewing Internal Control Report;
- examining and reporting on all related party transactions; and
- reviewing the pay scale of LAN Airlines' senior management.

Under Chilean law we are required, to the extent possible, to appoint a majority of independent directors to this committee. The corresponding independence requirements are set forth in Chilean Corporation Law, as amended by Law No. 19705 and relate to the relationship between the directors and the shareholders that control a corporation. A director is considered independent when he or she can be elected regardless of the voting of the controlling shareholders.

Pursuant to U.S. regulations, we are required to have an audit committee of at least three board members, which complies with the independence requirements set forth in Rule 10A-3 under the Securities Exchange Act of 1934. Given the similarity in the functions that must be performed by our Board of Directors' Committee and the audit committee, our Board of Directors' Committee serves as our Audit Committee for purposes of Rule 10A-3 under the Securities Exchange Act of 1934.

As of May 31, 2006, all of the members of our Board of Directors' Committee, which also serves as our Audit Committee, were independent under Rule 10A-3 under the Securities Exchange Act of 1934. As of May 31, 2006, the committee members were Mr. Jorge Awad Mehech, Mr. José Cox Donoso and Mr. Ramón Eblen Kadis. We pay each member of the committee 24 UFs per meeting.

## NYSE Corporate Governance Comparison

Pursuant to Section 303A.11 of the Listed Company Manual of the NYSE, we are required to provide a summary of the significant ways in which our corporate governance practices differ from those required for U.S. companies under the NYSE listing standards. We are a Chilean corporation with shares listed on the Santiago Stock Exchange, the *Bolsa Electrónica de Chile* and the Valparaíso Stock Exchange and ADSs on The New York Stock Exchange. Our corporate governance practices are governed by our bylaws, the Chilean Corporation Law and the *Ley de Mercado de Valores No. 18,045*, or the Securities Market Law.

The table below discloses the significant differences between our corporate governance practices and the NYSE standards.

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### NYSE Standards

**Director Independence.** *Majority of board of directors must be independent.*  
§303A.01

**Executive Sessions.** *Non-management directors must meet regularly in executive sessions without management. Independent directors should meet alone in an executive session at least once a year.* §303A.03

**Audit committee.** *Audit committee satisfying the independence and other requirements of Rule 10A-3 under the Securities Exchange Act of 1934, as amended, and the more stringent requirements under the NYSE standards is required.* §§303A.06, 303A.07

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### Our Corporate Governance Practice

Under Chilean law, we are not required to have a majority of independent directors.

Our board of directors' committee (all of whom are members of our board of directors) is composed of three directors, two of which must be independent if we have a sufficient number of independent directors on our board.

The definition of independence applicable to us pursuant to the Chilean Corporation Law differs in certain respects from the definition applicable to U.S. issuers under the NYSE rules.

Under the Chilean Corporation Law, a director is deemed to be independent if such member would have been elected as a Director at the Shareholders Meeting after excluding the votes of any controlling shareholder or party related to it.

There is no similar requirement under our bylaws or under applicable Chilean law.

We are in compliance with Rule 10A-3. We are not required to satisfy the NYSE independence and other audit committee standards that are not prescribed by Rule 10A-3.



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**NYSE Standards**

**Nominating/corporate governance committee.** *Nominating/corporate governance committee of independent directors is required. The committee must have a charter specifying the purpose, duties and evaluation procedures of the committee. §303A.04*

**Compensation committee.** *Compensation committee of independent directors is required, which must approve executive officer compensation. The committee must have a charter specifying the purpose, duties and evaluation procedures of the committee. §303A.05*

**Equity compensation plans.** *Equity compensation plans require shareholder approval, subject to limited exemptions.*

**Code of Ethics.** *Corporate governance guidelines and a code of business conduct and ethics is required, with disclosure of any waiver for directors or executive officers. §303A.10*

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**Our Corporate Governance Practice**

We are not required to have, and do not have, a nominating/corporate governance committee.

We are not required to have a compensation committee. Pursuant to the Chilean Corporation Law, our board of directors' committee must approve our senior management's compensation.

Under the Chilean Corporation Law, equity compensation plans require shareholder approval.

We have adopted a code of ethics applicable to our senior management, including our chief executive officer, our chief financial officer and our chief accounting officer, as well as to other employees. Our code of ethics is available upon request, in writing, by telephone or by e-mail, to the following address: Lan Chile S.A., Investor Relations Department, attention: Investor Relations, Av. Presidente Riesco 5711, Piso 20, Comuna Las Condes, Santiago, Chile, telephone (56-2) 565-3947, email: andres.bianchi@lan.com. We are required by Item 16B of Form 20-F to disclose any waivers granted to our chief executive officer, chief financial officer, principal accounting officer and persons performing similar functions.

**Employees**

As of December 31, 2005, we had a total of 15,099 employees, including:

- 1,015 pilots and copilots;
- 2,101 flight attendants;
- 1,977 maintenance personnel;
- 5,279 employees engaged in administrative or sales activities; and
- 4,727 employees engaged in a variety of operational activities.

Our flight operations, maintenance and customer ground operations personnel undergo training when they join us and throughout their employment with us. We invested in training approximately US\$6.8 million

in 2003, US\$7.6 million in 2004 and US\$6.6 million in 2005. We generally recruit our pilots from the Academia de Ciencias Aeronáuticas (at the Universidad Técnica Federico Santa María), aeroclubs and the armed forces. Before being promoted to the position of captain, first officers must have logged at least 4,000 flight hours and received the approval of a special pilots' committee. We provide ground-school training in Santiago, as well as in Lima and Quito for our Peruvian and Ecuadorian crews. We have signed an agreement with CAE (a Canadian firm specializing in flight training) to develop a pilot training center in Santiago de Chile. As of May 31, 2006, this training center included one Boeing 737-200; one Airbus A320, and one Boeing 767 Full Flight simulators. Our pilot staff also receives simulator training at sites in the United States and Brazil.

Our pilots are rated for only one aircraft type by local aeronautical authorities, and they are not cross-qualified between two or more aircraft types. Chilean regulations require pilots to be licensed as commercial pilots for a first officer position and as an airline transport pilot for a captain position, with specific type, function and special ratings for each aircraft to be flown, and to be medically certified as physically fit. Licenses and medical certifications are subject to periodic reevaluation, including flight simulator recurrent training, ground recurrent training, annual emergency procedures training, safety and security training and recent flying experience. Our pilots receive a variety of training, such as lectures, simulations and gaming and computer based training. Cabin crew must have initial and periodic competency fitness training.

Aircraft mechanics and maintenance supervisory personnel must be licensed and qualified for specific aircraft by the DGAC and other corresponding authorities in other countries in which we operate. We train our mechanics and maintenance supervisors in all programs required by both local DGAC and international authorities (such as the FAA or JAA), and Independent Travel Technology Association (or "ITTA") norms and regulations, those required by aircraft manufacturers and the training needs that we identify during our annual reviews. We present these programs during trainings that can last for up to four days for refresher courses and for up to 54 days for Boeing 767 line and base maintenance certification.

In December 1997, LAN Airlines and Lufthansa Technical Training GmbH created Lufthansa LAN Airlines Technical Training S.A. in Santiago to provide ourselves and third parties with technical training services and amenities, primarily for mechanics.

During 2003, we continued training sales and administrative personnel in areas such as service and sales quality. We also continued delivering programs aimed at improving leadership skills and applying e-learning techniques.

Since we have been run by the current management team, we have implemented a performance-related pay structure for our administrative, management and flight personnel, including performance-based bonuses and pay scales that reward foreign language proficiency in counter, technical and administrative personnel. During 2005, over 90% of our employees were eligible to receive performance related bonus payments that are linked to personal, team and corporate performance.

We have negotiated longer-term labor contracts with the labor unions in anticipation of their scheduled expirations, which under Chilean law are limited to a period of four years. In general, the expiration of our labor agreements with the several unions that represent our pilots and other personnel are staggered in a way that we avoid being in the position of having to renegotiate contract terms with substantially all of our pilots or other personnel at the same time.

The collective bargaining agreement between LanExpress and its pilots' union expires in November 2008. Three collective contracts are in place between LAN Airlines and its pilots (either through a union or employee groups). These contracts were negotiated in 2005 and early 2006 and expire between May 2009 and January 2010. LAN Cargo is also party to an employment agreement with its pilots that expires in April 2008.

LAN Airlines has also entered into collective bargaining agreements covering the majority of its flight attendants that expire at various times, ranging from April 2007 to March 2010. LAN Airlines and LanExpress have entered into collective bargaining agreements with its maintenance personnel that expire at various times, ranging from March 2007 to September 2008. The agreement with the union representing our administrative personnel expires in August 2009.

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The majority of LanArgentina's employees belong to industry-wide unions. In 2005, LanArgentina hired employees from another airline and agreed to maintain their employment conditions and labor stability for a period of three years.

We believe we generally have good relations with our employees and the unions, and expect to continue to enjoy good relations with our employees and the unions in the future. We also believe that we have built a solid base among our employees that will support and facilitate our growth plans. We can provide no assurance, however, that our employee compensation arrangements may not be subject to change or modification after the expiration of the contracts currently in effect, or that we will not be subject to labor-related disruptions due to strikes, stoppages or walk-outs.

We provide our employees with medical insurance and also grant other benefits, such as free and discounted airline tickets, to our permanent employees. We have never offered stock options to our employees. As required by Chilean law, we make obligatory contributions to the privatized pension fund system on behalf of our employees, but we do not maintain any separate program to provide pension, retirement or similar benefits to these or any other employees.

The following table sets forth the number of employees in various positions at LAN Airlines, LAN Airlines Cargo and our other subsidiaries.

Employees <sup>(1)</sup>	As of December 31,		
	2003	2004	2005
Administrative	2,486	3,135	3,222
Sales	1,845	1,838	2,057
Maintenance	1,383	1,620	1,977
Operations	3,294	4,028	4,727
Cabin crew	1,448	1,916	2,101
Cockpit crew	717	877	1,015
<b>Total</b>	<b>11,173</b>	<b>13,414</b>	<b>15,099</b>

<sup>(1)</sup> In 2005, approximately 64% of our employees worked in Chile, 28% in other Latin American countries and 8% in the rest of the world.

## ITEM 7. CONTROLLING SHAREHOLDERS AND RELATED PARTY TRANSACTIONS

### Controlling Shareholders

Pursuant to agreements signed in July 2004, two shareholder groups control the Company. These shareholder groups are:

- the Cueto Group, which includes Mr. Juan Cueto Sierra, Mr. Juan José Cueto Plaza, Mr. Ignacio Cueto Plaza, Mr. Enrique Cueto Plaza and certain members of their family;
- the Piñera Group, which includes Mr. Sebastián Piñera Echenique and certain members of his family;

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We collectively refer to these shareholder groups as “Controlling Shareholders”. As of May 31, 2006, our Controlling Shareholders owned 54.0% of our voting common shares. While the common shares owned by the Controlling Shareholders do not have different voting rights than the common shares owned by our other shareholders, these Controlling Shareholders are entitled to elect a majority of the members of our board of directors and are in a position to direct our management and to control substantially all matters that are to be decided by a vote of shareholders.

The agreements signed by our Controlling Shareholders provide for a joint-action agreement and a right of first refusal agreement in connection with 45.0% of our common shares. Under the joint-action agreement, the Controlling Shareholders agreed to act coordinately on all matters pertaining to the Company’s management, both at shareholders’ meetings and meetings of the board of directors. Under the right of first refusal agreement between both groups, the shares included under this agreement are subject to reciprocal rights of first refusal in connection with any future sale to a third party.

As of May 31, 2006, a third shareholder group, which includes our director Ramon Eblen Cadiz, owned approximately 10% of our common shares. Because this group can influence our management, we have classified this group as a “Principal Shareholder”.

The table below sets forth the beneficial ownership of common shares as of May 31, 2006, broken down between our Controlling Shareholders, other principal shareholder, and minority shareholders.

	Beneficial ownership (as of May 31, 2006)	
	Number of shares of common stock beneficially owned	Percentage of common stock beneficially owned
<b>Shareholder</b>		
<b>Cueto Group</b>		
Inversiones Costa Verde Limitada y Compañía en Comandita por Acciones	86,133,567	27.0%
Total	86,133,567	27.0%
<b>Piñera Group</b>		
Inversiones Santa Cecilia S.A.	20,417,920	6.4%
Axxion S.A.	65,827,874	20.6%
Total	86,245,794	27.0%
Other principal shareholder	31,778,049	10.0%
Others	114,751,680	36.00%
<b>Total</b>	<b>318,909,090</b>	<b>100.0%</b>

At May 31, 2006, investors outside of Chile held 18% of our capital stock in the form of ADSs, and other minority investors held 18% in the form of common shares. It is not practicable for us to determine the number of ADSs or common shares beneficially owned in the United States. At May 31, 2006, we had 1,032 record holders of our common shares. It is not practicable for us to determine the portion of shares held in Chile or the number of record holders in Chile.

## **Related Party Transactions**

We have engaged in a variety of transactions with our affiliates, including entities owned or controlled by certain of our controlling shareholders. Set out below is a description of the material transactions between LAN Airlines and its affiliates. It is our policy not to engage in any transaction with or for the benefit of any shareholder or member of the board of directors, or any entity controlled by such a person or in which such a person has a substantial economic interest, unless the transaction is related to our business and the price and other terms are at least as favorable to us as those that could be obtained on an arm’s-length basis from a third party.

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### *Real Estate Transactions*

During the fourth quarter of 2003, LAN Airlines acquired office space and other ancillary facilities for US\$7.3 million from Inmobiliaria San Luis Dos S.A., an entity in which the Cueto Group of our majority shareholders holds a minority stake. This office space enabled us to move some of our administrative and commercial staff to a more central location in Santiago. This transaction was carried out at market prices and in accordance with Chilean law, was approved by our board of directors' committee and was disclosed at our annual shareholders' meeting.

### *Other Transactions*

In addition to the transactions discussed above, in the ordinary course of our business we render to and receive from related companies services of various types, including aircraft leases, aircraft interchanges, freight transportation and reservation services. Such transactions, none of which is individually material, are summarized in Note 14 on page F-24 to our audited consolidated financial statements for the fiscal year ended December 31, 2005.

## **ITEM 8. FINANCIAL INFORMATION**

### **Consolidated Financial Statements**

See Item 18, "Financial Statements" and pages F-1 through F-55.

### **Other Financial Information**

#### *Legal and Arbitration Proceedings*

We are involved in routine litigation and other proceedings relating to the ordinary course of our business. On July 30, 1997, the Chilean Antitrust Commission imposed a fine on us of approximately US\$345,000 in connection with a complaint filed by DAP Airlines, or DAP, alleging that we employed anti-competitive tactics by reducing our prices on certain of our routes and refusing to perform maintenance services on DAP aircraft. On January 8, 1998, DAP filed a demand for indemnification against Lan Airlines, National Airlines and Lan Cargo, jointly and severally, in the amount of approximately Ch\$6.4 billion (approximately US\$10.8 million according to the observed exchange rate as of May 31, 2005). In June 2000, the courts ruled in favor of DAP in the amount of Ch\$342 million (approximately US\$580,000 according to the observed exchange rate as of May 31, 2005). We appealed the decision to the Chilean Supreme Court in July 2004, and a final ruling in the appeal is still pending.

On February 14, 2006 the U.S. Department of Justice and the European Commission initiated investigations involving numerous cargo airlines around the world, including Lan Cargo, for alleged anti-competitive practices in the air cargo industry, particularly the alleged fixing of Fuel Surcharge and air cargo rates. The investigations themselves do not imply that Lan Cargo has been charged with or has engaged in any prohibited activity. The investigations are expected to last at least several months. The investigation by the U.S. Department of Justice has prompted the filing of numerous Civil Class Actions against many airlines including Lan Cargo and Lan Airlines in Canada and the United States.

On April 26, 2006, a proceeding was filed against Lan Airlines and Lan Cargo before the Chilean Antitrust Court relative to the alleged abusive exercise of their dominant position in the air cargo business to and from Punta Arenas, Chile, and in the customs storage business in that city, where Lan Airlines participates through its subsidiary Fast Air Almacenes de Carga S.A. The proposed fine is of 2,000 Unidades Tributarias Mensuales (equal to approximately US\$ 120,000) for each Lan Airlines and Lan Cargo.

#### *Dividend Policy*

In accordance with Chilean law, Lan Airlines must distribute cash dividends equal to at least 30% of its annual net income calculated in accordance with Chilean GAAP, unless otherwise decided by a unanimous vote of the holders of all issued shares and unless and except to the extent it has accumulated losses. If there is

no net income in a given year, Lan Airlines can elect but is not legally obligated to distribute dividends out of retained earnings. The board of directors may declare interim dividends out of profits earned during such interim period. Pursuant to Lan Airlines' by-laws, the annual cash dividend is approved by the shareholders at the annual ordinary shareholders' meeting held between February 1 and April 30 of the year following the year with respect to which the dividend is proposed. All outstanding common shares are entitled to share equally in all dividends declared by Lan Airlines.

Holders of ADSs offered hereby will be entitled to receive dividends on the underlying common shares to the same extent as holders of common shares. Holders of ADRs on the applicable record dates will be entitled to receive dividends paid on the common shares represented by the ADSs evidenced by such ADRs after the closing of the offering. Dividends payable to holders of ADSs will be paid by us to the depositary in Chilean pesos and remitted by the depositary to such holders net of foreign currency conversion fees and expenses of the depositary and will be subject to Chilean withholding tax currently imposed at a rate of 35% (subject to credits in certain cases as described under "Taxation"). Owners of the ADSs will not be charged any dividend remittance fee by the depositary with respect to cash dividends. See "Description of American Depositary Receipts—Dividends, Other Distributions and Rights" and "Taxation".

Chilean law requires that holders of shares of Chilean companies that are not residents of Chile register as foreign investors under one of the foreign investment regimes established by Chilean law in order to have dividends, sale proceeds or other amounts with respect to their shares remitted outside Chile through the Formal Exchange Market (*Mercado Cambiario Formal*). Under our Foreign Investment Contract, the depositary, on behalf of ADS holders, will be granted access to the Formal Exchange Market to convert cash dividends from pesos to U.S. dollars and to pay such U.S. dollars to ADS holders outside Chile.

## **ITEM 9. THE OFFER AND LISTING**

### **Stock Price History**

The principal trading market for our common shares is the Santiago Stock Exchange. The common shares have been listed on the Santiago Stock Exchange under the symbol "LAN" since 1989, and the ADSs have been listed on The New York Stock Exchange under the symbol "LFL" since November 7, 1997. The common shares also trade on the *Bolsa de Valores de Valparaíso* and the *Bolsa Electrónica de Chile*. The outstanding ADSs are identified by the CUSIP number 501723100. The following table sets forth, for the periods indicated, the high and low closing sale prices on the Santiago Stock Exchange for the common shares and the high and low closing prices on The New York Stock Exchange for the common shares represented by ADSs. The information set forth in the table below reflects actual historical amounts and has not been restated in constant Chilean pesos.

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Year ended December 31,	Ch\$ per Common Share		US\$ per ADS	
	Low	High	Low	High
<b>2001</b>	775.00	1,339.90	5.26	10.14
<b>2002</b>	520.00	960.00	3.40	7.55
<b>2003</b>				
First Quarter	735.00	875.00	5.15	6.16
Second Quarter	770.00	1,150.00	5.38	8.20
Third Quarter	1,145.00	1,495.00	8.07	11.28
Fourth Quarter	1,520.00	2,100.10	11.66	17.70
<b>2004</b>				
First Quarter	2,010.00	2,300.00	16.86	19.80
Second Quarter	2,105.50	2,550.00	16.85	20.60
Third Quarter	2,340.10	3,025.00	18.58	25.00
Fourth Quarter	2,640.00	3,670.10	22.30	32.90
<b>2005</b>				
First Quarter	3,420.00	4,170.00	30.25	35.98
Second Quarter	3,885.00	4,370.00	33.54	38.05
Third Quarter	3,240.00	4,280.00	30.69	37.55
Fourth Quarter	3,346.90	3,845.90	31.31	37.55
<b>2006</b>				
First Quarter	3,780.00	4,250.00	36.24	40.85
Monthly Prices				
January, 2006	3,780.00	4,199.90	36.58	40.30
February, 2006	3,815.10	4,250.00	36.24	40.85
March, 2006	4,020.00	4,236.10	38.16	40.70
April, 2006	3,740.00	4,149.90	36.16	39.76
May, 2006	3,520.00	4,050.00	32.78	39.40
June, 2006 <sup>(1)</sup>	3,500.00	3,797.80	31.80	35.60

Sources: Santiago Stock Exchange and The New York Stock Exchange.

<sup>(1)</sup> Period through June 15, 2006.

As of May 31, 2006, a total of 318,909,090 common shares were outstanding, including 57,412,775 common shares represented by ADSs.

## Trading

The Chilean stock market, which is regulated by the SVS under Law 18,045 of October 22, 1981, as amended, which we refer to as the “Securities Market Law”, is one of the most developed among emerging markets, reflecting the particular economic history and development of Chile. The Chilean government’s policy of privatizing state-owned companies, implemented during the 1980s, led to an expansion of private ownership of shares, resulting in an increase in the importance of stock markets. Privatization extended to the social security system, which was converted into a privately managed pension fund system. These pension funds have been allowed, subject to certain limitations, to invest in stocks and are currently major investors in the stock market. Some market participants, including pension fund administrators, are highly regulated with respect to investment and remuneration criteria, but the general market is less regulated than the U.S. market with respect to disclosure requirements and information usage.

The Santiago Stock Exchange is Chile’s principal exchange and accounts for approximately 85.1% of securities traded in Chile. Approximately 14.4% of equity trading is conducted on the Chilean Electronic Stock Exchange, an electronic trading market created by banks and non-member brokerage houses. The remaining equity trading is conducted on the Valparaíso Stock Exchange.

Equities, closed-end funds, fixed-income securities, short-term and money market securities, gold and U.S. dollars are traded on the Santiago Stock Exchange. In 1991, the Santiago Stock Exchange initiated a futures market with two instruments: U.S. dollar futures and Selective Shares Price Index, or IPSA, futures. Securities are traded primarily through an open voice auction system, a firm offers system or the daily auction. Trading through the open voice system occurs on each business day between 9:30 a.m. to 4:30 p.m. The Santiago Stock Exchange has an electronic system of trade, called *Telepregón*, which operates continuously for stocks trading in high volumes from 9:30 a.m. to 4:30 p.m. The Chilean Electronic Stock Exchange operates continuously from 9:30 a.m. to 4:30 p.m. (or 5:30 p.m., depending on the period of the year) on each business day. In February 2000, the Santiago Stock Exchange Off-Shore Market began operations. In the Off-Shore Market, publicly offered foreign securities are traded and quoted in United States dollars.

## ITEM 10. ADDITIONAL INFORMATION

### Memorandum and Articles of Association

Set forth below is information concerning our share capital and a brief summary of certain significant provisions of our by-laws and Chilean law. This description contains all material information concerning the common shares but does not purport to be complete and is qualified in its entirety by reference to our by-laws, the Chilean Corporation Law and the Securities Market Law, each referred to below. For additional information regarding the common shares, reference is made to our by-laws, a copy of which are included as Exhibit 1.1 to this annual report on Form 20-F.

#### Organization and Register

Lan Airlines is a publicly-held stock corporation (*sociedad anónima abierta*) incorporated under the laws of Chile. Lan Airlines was incorporated by a public deed dated December 30, 1983, an abstract of which was published in the Chilean Gazette (*Diario Oficial de la República de Chile*) No. 31.759 on December 31, 1983, and registered on page 20,341, No. 11,248 of the Chilean Real Estate and Commercial Registrar (*Registro de Comercio del Conservador de Bienes Raíces y Comercio de Santiago*) for the year 1983. Our corporate purpose, as stated in our by-laws, is to provide a broad range of transportation and related services, as more fully set forth in Article Four thereof.

#### General

Shareholders' rights in a Chilean company are generally governed by the company's by-laws. Article 22 of the Chilean Corporation Law states that the purchaser of shares of a company implicitly accepts its by-laws and any agreements adopted at shareholders' meetings. Additionally, the Chilean Corporation Law regulates the government and operation of corporations ("*sociedades anónimas*", or S.A.) and provides for certain shareholder rights. Article 137 of the Chilean Corporation Law provides that the provisions of the Chilean Corporation Law take precedence over any contrary provision in a corporation's by-laws. The Chilean Corporation Law and our by-laws also provide that all disputes arising among shareholders in their capacity as such or between us or our administrators and the shareholders may either be submitted to arbitration in Chile or to the courts of Chile at the election of the plaintiff initiating the action. Finally, Decree-Law 3500, which allows pension funds to invest in the stock of qualified corporations, indirectly affects corporate governance and prescribes certain rights of shareholders. The Chilean Corporation Law sets forth the rules and requirements for establishing publicly held corporations. Article 2 of the Chilean Corporation Law defines publicly held corporations as corporations:

- with 500 or more shareholders;
- in which 100 or more shareholders own at least 10% of the subscribed capital (excluding any direct or indirect individual holdings exceeding 10%); and
- which have voluntarily registered their shares in the Security Register of the SVS.

The framework of the Chilean securities market is regulated by the Chilean exchange entity, the SVS, under the Securities Market Law and the Chilean Corporation Law, which imposes certain disclosure



requirements, restricts insider trading, prohibits price manipulation and protects minority investors. Both the Chilean Corporation Law and the Securities Market Law state rules and requirements for establishing publicly held corporations. In particular, the Securities Market Law establishes requirements for public offerings, stock exchanges and brokers and outlines disclosure requirements for corporations that issue publicly offered securities.

#### *Ownership Restrictions*

Under Article 12 of the Securities Market Law and Circular 585 of the SVS, certain information regarding transactions in shares of publicly held corporations must be reported to the SVS and the Chilean stock exchanges on which the shares are listed. Since the ADRs are deemed to represent the shares underlying the ADSs, transactions in ADRs will be subject to those reporting requirements. Among other matters, beneficial owners of ADSs will be required to report to the SVS and the Chilean stock exchanges within two stock exchange business days:

- any direct or indirect acquisition or sale of shares that results in the holder's acquiring or disposing, directly or indirectly, of 10% or more of the corporation's total subscribed shares; and
- any direct or indirect acquisition or sale of shares or options to buy or sell shares, in any amount, if made by a holder of 10% or more of a publicly held corporation's total subscribed shares, or if made by a director, liquidator, principal officer, general manager or manager of such corporation.

In addition, majority shareholders must state in their report whether their purpose is to acquire control of the company or if they are making a financial investment.

Under Article 54 of the Securities Market Law and under SVS regulations, persons or entities that intend to acquire control, whether directly or indirectly, of a publicly traded company, must follow certain notice requirements, regardless of the acquisition vehicle or procedure or whether the acquisition will be made through direct subscriptions or private transactions. The potential acquiror must first send a written communication to the target corporation, any companies controlling or controlled by the target corporation, the SVS and the Chilean stock exchanges on which the securities are listed, stating, among other things, the person or entity purchasing or selling and the price and conditions of any negotiations.

The potential acquiror must also inform the public of its planned acquisition at least ten business days prior to the date on which the transaction is to close, and in any event, as soon as negotiations regarding the change of control begin (*i.e.*, when information and documents concerning the target are delivered to the potential acquiror). Notice is made through a filing with the SVS, the relevant Chilean stock exchanges and any companies controlling or controlled by the target corporation and through a notice published in two Chilean newspapers, and must also state, among other things, the person or entity purchasing or selling and the price and conditions of any negotiations.

In addition to the foregoing, Article 54A of the Securities Market Law requires that within two business days of the completion of the transactions pursuant to which a person has acquired control of a publicly traded company, a notice shall be published in the same newspapers in which the notice referred to above was published and notices shall be sent to the same persons mentioned in the preceding paragraphs.

A beneficial owner of ADSs intending to acquire control of Lan Airlines will be subject to the foregoing reporting requirements.

The provisions of the aforementioned articles do not apply whenever the acquisition is being made through a tender or exchange offer.

Title XXV of the Securities Market Law on tender offers and SVS regulations provide that the following transactions shall be carried out through a tender offer:

- An offer which allows a person to take control of a publicly traded company, unless the shares are being sold by a controlling shareholder of such company at a price in cash which is not substantially higher than the market price and the shares of such company are actively traded on a stock exchange;
- An offer for all the outstanding shares of a publicly traded company upon acquiring two thirds or more of its voting shares (this offer must be made at a price not lower than the price at which appraisal rights may be exercised, that is, book value if the shares of the company are not actively traded or, if the shares of the company are actively traded, the weighted average price at which the stock has been traded during the two months immediately preceding the acquisition); and
- An offer for a controlling percentage of the shares of a listed operating company if such person intends to take control of the company (whether listed or not) controlling such operating company, to the extent that the operating company represents 75.0% or more of the consolidated net worth of the holding company.

Article 200 of the Securities Market Law prohibits any shareholder that has taken control of a publicly traded company from acquiring, for a period of 12 months from the date of the transaction that granted it control of the publicly traded company, a number of shares equal to or higher than 3.0% of the outstanding issued shares of the target without making a tender offer at a price per share not lower than the price paid at the time of taking control. Should the acquisition from the other shareholders of the company be made on the floor of a stock exchange and on a pro rata basis, the controlling shareholder may purchase a higher percentage of shares, if so permitted by the regulations of the stock exchange.

Title XV of the Securities Market Law sets forth the basis for determining what constitutes a controlling power, a direct holding and a related party.

#### *Capitalization*

Under Chilean law, the shareholders of a company, acting at an extraordinary shareholders' meeting, have the power to authorize an increase in the company's share capital. When an investor subscribes for issued shares, the shares are registered in that investor's name, even without payment therefore, and the investor is treated as a shareholder for all purposes except with regard to receipt of dividends and return of capital. The investor becomes eligible to receive dividends once it has paid for the shares, or, if it has paid for only a portion of such shares, it is entitled to receive a corresponding pro rata portion of the dividends declared with respect to such shares, unless the company's by-laws provide otherwise. If an investor does not pay for shares for which it has subscribed on or prior to the date agreed upon for payment, the company is entitled under Chilean law to auction the shares on the appropriate stock exchange, and it has a cause of action against the investor to recover the difference between the subscription price and the price received for the sale of those shares at auction. However, until such shares are sold at auction, the investor continues to exercise all the rights of a shareholder (except the right to receive dividends and return of capital). Shares issued but not paid for within the period determined by the extraordinary shareholders' meeting for their payment (which in any case cannot exceed three years from the date of such shareholders' meeting which authorizes the increase in capital) will be canceled and will no longer be available for issuance by us. Fully paid shares are not subject to further calls or assessments or to liabilities of Lan Airlines.

At May 31, 2006, our share capital consisted of 318,909,090 common shares, all of which were subscribed and fully paid. Chilean law recognizes the right to issue common and preferred shares. To date, we have issued and are authorized by our shareholders to issue only common shares.

#### *Preemptive Rights and Increases in Share Capital*

The Chilean Corporation Law requires Chilean companies to offer existing shareholders the right to purchase a sufficient number of shares to maintain their existing percentage of ownership in a company whenever that company issues new shares for cash. Under this requirement, any preemptive rights will be offered by us to the depositary as the registered owner of the common shares underlying the ADSs, but holders of ADSs and shareholders located in the United States will not be allowed to exercise preemptive

rights with respect to new issuances of shares by us unless a registration statement under the Securities Act is effective with respect to those common shares or an exemption from the registration requirements thereunder is available.

Under the procedures established by the Central Bank of Chile, a Chilean company with an existing ADR program under Chapter XXVI of the Compendium of Foreign Exchange Regulations of the Central Bank of Chile may apply to amend its foreign investment contract with such Bank so as to extend the benefits of such contract to new shares issued pursuant to preemptive rights offerings to existing ADS owners and enable them to exercise their preemptive rights. Although approval is expected to be granted upon satisfaction of certain formal requirements, any such amendment (which will be deemed to incorporate all laws and regulations applicable to international offerings in effect as of date of the amendment) will be reviewed by the Central Bank of Chile on a case-by-case basis. These procedures are expected to make it easier for Chilean companies to offer preemptive rights to ADS holders in connection with capital increases.

We intend to evaluate at the time of any preemptive rights offering the costs and potential liabilities associated with the preparation and filing of a registration statement with the Securities and Exchange Commission, as well as the indirect benefits of enabling the exercise by the holders of ADSs and shareholders located in the United States of preemptive rights and any other factors we consider appropriate at the time. No assurances can be given that any registration statement would be filed. If preemptive rights are not made available to ADS holders, the depositary may sell those holders' preemptive rights and distribute the proceeds thereof if a secondary market for such rights exists and a premium can be recognized over the cost of such sale. See "Description of American Depositary Receipts—Dividends, Other Distributions and Rights". In the event that the depositary does not sell such rights at a premium over the cost of any such sale, all or certain holders of ADRs may receive no value for the preemptive rights. The inability of holders of ADSs to exercise preemptive rights in respect of common shares underlying their ADSs could result in a change in their percentage ownership of common shares following a preemptive rights offering.

Under Chilean law, preemptive rights are exercisable or freely transferable by shareholders during a 30-day period commencing upon publication of the official notice announcing the start of the preemptive rights period in the newspaper designated by the shareholders. The preemptive right of the shareholders is the pro rata amount of the shares registered in their name in the shareholders' registry as of the fifth business day prior to the date of publication of the notice announcing the start of the preemptive rights period. During such 30-day period (except for shares as to which preemptive rights have been waived), Chilean companies are not permitted to offer any newly issued common shares for sale to third parties. For an additional 30-day period, Chilean publicly held corporations are not permitted to offer any unsubscribed common shares for sale to third parties on terms that are more favorable to the purchaser than those offered to shareholders. At the end of such additional 30-day period, Chilean publicly held corporations are authorized to sell non-subscribed shares to third parties on any terms, provided they are sold on a Chilean stock exchange.

#### *Directors*

Our by-laws provide for a board of nine directors. Compensation to be paid to directors must be approved by vote at the annual shareholders' meeting. We hold elections for all positions on the board of directors every two years.

Under the Chilean Corporation Law, transactions in which a director is materially interested (including a transaction in which a director proposes to borrow from the company) must be conducted on an arm's-length basis and must satisfy certain disclosure requirements. These transactions include transactions involving a director's spouse or close relatives, transactions involving other companies on whose board such director also serves or transactions with other companies where the director controls 10% of such company (directly or indirectly). Corporations may enter into transactions in which a director is materially interested if the transaction has been approved by the board of directors (which must be disclosed at the next shareholders' meeting) and is consistent with standards of fairness similar to those that normally prevail in the market. Transactions which do not meet these conditions are valid and enforceable, but each director who approved the transaction is jointly and severally liable for damages suffered by the company, the shareholders or any

interested third parties, and the director who directly or indirectly benefits from the transaction must pay all benefits received from such transaction to the corporation. The directors are also subject to fines and administrative sanctions.

Whenever a transaction in which a director is materially interested exceeds 1% of the net worth of the company and exceeds the equivalent of 2,000 UF (approximately US\$65,000 as of the date of this annual report) or whenever such a transaction exceeds 20,000 UF, the board of directors of the company must determine whether the transaction complies with arm-length's conditions similar to those prevailing in the market. If the board of directors is unable to determine those conditions, the board, without the vote of the interested director, may approve or reject the transaction or may appoint two independent experts to provide an opinion. The experts' reports must indicate the terms of the transaction and in the case of non-cash assets, must indicate the planned method of payment. Experts' valuation reports must be made available to the shareholders and to the board of directors for a period of 20 business days. The board of directors may decide to approve or reject the proposed transaction only after this 20-day period has expired. If shareholders representing 5% of the voting shares determine, within the 20-day period, that the transaction is not favorable to the corporation's interests or that the reports of the experts are substantially different, those shareholders may require the board of directors to call an extraordinary shareholders' meeting. Approval of the transaction then requires the affirmative vote of two-thirds of the voting shares of the company.

#### *Shareholders' Meetings and Voting Rights*

The Chilean Corporation Law requires that an ordinary annual meeting of shareholders be held within the first four months of each year (generally they are held in April, but in any case following the preparation of our financial statements, including the report of our auditors, for the previous fiscal year). Lan Airlines' by-laws further provide that the ordinary annual meeting of shareholders must take place between February 1 and April 30. The shareholders at the ordinary annual meeting approve the annual financial statements, including the report of our auditors, the annual report, the dividend policy and the final dividend on the prior year's profits, elect the board of directors (in our case, every two years or earlier if a vacancy occurs) and approve any other matter that does not require an extraordinary shareholders' meeting. The most recent ordinary annual meeting of our shareholders was held on April 28, 2006. Extraordinary shareholders' meetings may be called by the board of directors, if deemed appropriate, and ordinary or extraordinary shareholders' meetings must be called by the board of directors when requested by shareholders representing at least 10% of the issued voting shares or by the SVS.

Notice to convene the ordinary annual meeting or an extraordinary meeting is given by means of three notices which must be published in a newspaper of our corporate domicile (currently Santiago de Chile) designated by the shareholders at their annual meeting and, if the shareholders fail to make such designation, the notice must be published in the Official Journal pursuant to legal requirements. The first notice must be published not less than 15 days and not more than 20 days in advance of the scheduled meeting. Notice also must be mailed not less than 15 days in advance of the meeting to each shareholder and to the SVS and the Chilean stock exchanges. Currently, we publish our official notice in the newspaper *La Tercera*.

The quorum for a shareholders' meeting is established by the presence, in person or by proxy, of shareholders representing a majority of our issued common shares. If a quorum is not present, the meeting can be reconvened, and at a second meeting the shareholders present are deemed to constitute a quorum regardless of the percentage of the common shares that they represent.

Only shareholders registered with us on the fifth business day prior to the date of a meeting are entitled to attend and vote their shares. A shareholder may appoint another individual (who need not be a shareholder) as his proxy to attend and vote on his behalf. Proxies addressed to us that do not designate a person to exercise the proxy are taken into account in order to determine if there is a sufficient quorum to hold the meeting, but the shares represented thereby are not entitled to vote at the meeting. Every shareholder entitled to attend and vote at a shareholders' meeting has one vote for every share subscribed.

The following matters can only be considered at an extraordinary shareholders' meeting:

- our dissolution;
- a merger, transformation, division or other change in our corporate form or the amendment of our by-laws;
- the issuance of bonds or debentures convertible into shares;
- the conveyance of 50% or more of our assets or 50% or more of our liabilities;
- granting of a security interest or a personal guarantee, unless to secure or guarantee the obligations of a subsidiary, in which case only the approval of the board of directors will suffice; and
- other matters that require shareholder approval according to Chilean law or the by-laws.

The matters referred to in the first four items listed above may only be approved at a meeting held before a notary public, who shall certify that the minutes are a true record of the events and resolutions of the meeting.

The by-laws establish that resolutions are passed at shareholders' meetings by the affirmative vote of an absolute majority of those voting shares present or represented at the meeting. However, under the Chilean Corporation Law, the vote of a two-thirds majority of the outstanding voting shares is required to approve any of the following actions:

- a change in our corporate form, division or merger with another entity;
- amendment to our term of existence, if any;
- our early dissolution;
- change in our corporate domicile;
- decrease of our capital stock;
- approval of contributions and the assessment thereof whenever consisting of assets other than money;
- any modification of the authority reserved for the shareholders' meetings or limitations on the powers of the board of directors;
- decrease in the number of members of the board of directors;
- the conveyance of 50% or more our assets, either including or not including our liabilities, or the submittal of, or changes to, any business plan that contemplates the conveyance of assets in an amount that exceeds the percentage mentioned above;
- the form that dividends are paid in;
- granting a security interest or a personal guarantee that exceeds 50% of our assets, unless to secure or guarantee the obligations of a subsidiary, in which case only approval of the board of directors will suffice;
- the acquisition of our own shares, when, and on the terms and conditions, permitted by law;
- all other matters provided for in the by-laws; and
- the correction of any formal defect in our incorporation or any amendment to our by-laws that refers to any of the matters indicated in the first thirteen items listed above.

Amendments to the by-laws that have the effect of establishing, modifying or eliminating any special rights pertaining to any series of shares require the consenting vote of holders of two-thirds of the shares of the affected series.

In general, Chilean law does not require a publicly held corporation to provide the level and type of information that the U.S. securities laws require a reporting company to provide to its shareholders in connection with a solicitation of proxies. However, shareholders are entitled to examine the books of the company within the 15-day period before the scheduled meeting. No later than the first notice summoning an ordinary shareholder's meeting, the board of directors of a publicly held corporation shall send to every shareholder a copy of the annual report and the financial statements of the company. However, the SVS may authorize companies that have a large number of shareholders to limit the sending of such documents only to those shareholders who have a number of shares exceeding a certain number, and, in any case, to any shareholder that has required of the company such sending. Shareholders who do not fall into this category but who request it must be sent a copy of our annual report. In addition to these requirements, we regularly

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have provided, and currently intend to continue to provide, together with the notice of shareholders' meeting, a proposal for the final annual dividend for shareholder approval. See "Dividend and Liquidation Rights".

The Chilean Corporation Law provides that, whenever shareholders representing 10% or more of the issued voting shares so request, a Chilean company's annual report must include such shareholders' comments and proposal in relation to the company's affairs. Similarly, the Chilean Corporation Law provides that whenever the board of directors of a publicly held corporation convenes an ordinary meeting of the shareholders and solicits proxies for that meeting, or distributes information supporting its decisions or other similar material, it is obligated to include as an annex to its annual report any pertinent comments and proposals that may have been made by shareholders owning 10% or more of the company's voting shares who have requested that such comments and proposals be included.

### *Dividend and Liquidation Rights*

In accordance with Chilean Law, Lan Airlines must distribute an annual cash dividend equal to at least 30% of its annual net income calculated in accordance with Chilean GAAP, unless otherwise decided by a unanimous vote of the holders of all issued shares, and unless and except to the extent it has accumulated losses. If there is no net income in a given year, Lan Airlines can elect but is not legally obligated to distribute dividends out of retained earnings. All outstanding common shares are entitled to share equally in all dividends declared by Lan Airlines. See "Dividends".

Lan Airlines may grant an option to its shareholders to receive any dividend in excess of 30% of net income in cash, in its own shares or in shares of publicly held corporations held by it. Shareholders who do not expressly elect to receive a dividend other than in cash are legally presumed to have decided to receive the dividend in cash. A U.S. holder of ADSs may, in the absence of an effective registration statement under the Securities Act or an available exemption from the registration requirement thereunder, effectively be required to receive a dividend in cash. See "Preemptive Rights and Increases of Share Capital".

Dividends that are declared but not paid within the appropriate time period set forth in the Chilean Corporation Law (as to minimum dividends, 30 days after declaration; as to additional dividends, the date set for payment at the time of declaration) are adjusted to reflect the change in the value of the UF. The UF is a daily indexed, Chilean peso-denominated accounting unit designed to discount the effect of Chilean inflation and it is based on the previous month's inflation rate as officially determined. Such dividends also accrue interest at the then-prevailing rate for UF-denominated deposits during such period. The right to receive a dividend lapses if it is not claimed within five years from the date such dividend is payable.

In the event of Lan Airlines' liquidation, the holders of fully paid common shares would participate pro rata in the distribution of assets remaining after payment of all creditors. Holders of shares not fully paid will participate in such distribution in proportion to the amount paid.

### *Approval of Financial Statements*

The board of directors is required to submit our consolidated financial statements to the shareholders for their approval at the annual ordinary shareholders' meeting. If the shareholders reject the financial statements, the board of directors must submit new financial statements not later than 60 days from the date of that meeting. If the shareholders reject the new financial statements, the entire board of directors is deemed removed from office and a new board is elected at the same meeting. Directors who approved such financial statements are disqualified for re-election for the ensuing period.

### *Right of Dissenting Shareholders to Tender Their Shares*

The Chilean Corporation Law provides that, upon the adoption at an extraordinary meeting of shareholders of any of the resolutions enumerated below, dissenting shareholders acquire the right to withdraw and to compel the company to repurchase their shares, subject to the fulfillment of certain terms and conditions. However, such right shall be suspended if we are declared bankrupt or are subject to a creditor's agreement pursuant to Title XII of the Chilean Bankruptcy Law. In the case of holders of ADRs, however, in

order to exercise such rights, holders of ADRs would be required to first withdraw the common shares represented by the ADRs pursuant to the terms of the deposit agreement. Such holders of ADRs would need to perfect the withdrawal of the common shares on or before the fifth business day prior to the date of the meeting.

“Dissenting shareholders” are defined as those who attend a shareholders’ meeting and vote against a resolution which results in the withdrawal right, or, if absent at such a meeting, those who state in writing to the company their opposition to such resolution within the following 30 days. Dissenting shareholders must perfect their withdrawal rights by tendering their stock to the company within 30 days after adoption of the resolution.

The price paid to a dissenting shareholder of a publicly held corporation is the weighted average of the sales prices for the shares as reported on the Chilean stock exchanges on which the shares are quoted for the two-month period preceding the event giving rise to the withdrawal right. If, because of the volume, frequency, number and diversity of the buyers and sellers, the SVS determines that the shares are not shares actively traded on a stock exchange (*acciones de transaccion bursatil*), the price paid to the dissenting shareholder is the book value. Book value for this purpose equals paid capital plus reserves and profits, less losses, divided by the total number of subscribed shares (whether entirely or partially paid). For the purpose of making this calculation, the last annual balance sheet is used and adjusted to reflect inflation up to the date of the shareholders’ meeting that gave rise to the withdrawal right.

The resolutions that result in a shareholder’s right to withdraw are the following:

- the transformation of the company into an entity that is not a publicly held corporation governed by the Chilean Corporation Law;
- the merger of the company with or into another company;
- the conveyance of 50% or more of the assets of the company, whether or not such sale includes the company’s liabilities;
- the creation of preferential rights for a class of shares or an amendment to those already existing, in which case the right to withdraw only accrues to the dissenting shareholders of the class or classes of shares adversely affected;
- the correction of any formal defect in the incorporation of the company or any amendment to the company’s by-laws that grants the right to withdraw;
- the granting of security interests or personal guarantees to secure or guarantee third parties’ obligations exceeding 50% of the company’s assets, except with regard to subsidiaries;
- resolutions of the shareholders’ meeting approving the deregistration of the company from the Securities Registry of the SVS; and
- such other causes as may be established by the company’s by-laws (no such additional resolutions currently are specified in our by-laws).

In addition, shareholders of publicly held corporations have the right to withdraw if a person acquires two-thirds or more of the outstanding shares of such corporation and does not make a tender offer for the remaining shares within 30 days after acquisition.

Under Article 69(bis) of the Chilean Corporation Law, the right to withdraw also is granted to shareholders (other than pension funds that administer private pension plans under the national pension law), under certain terms and conditions, if a company were to become controlled by the Chilean government, directly or through any of its agencies, and if two independent rating agencies downgrade the rating of its stock from first class because of certain actions specified in Article 69(bis) undertaken by the company or the Chilean government that affect negatively and substantially the earnings of the company. Shareholders must perfect their withdrawal rights by tendering their shares to the company within 30 days of the date of the publication of the new rating by two independent rating agencies. If the withdrawal right is exercised by a shareholder invoking Article 69(bis), the price paid to the dissenting shareholder shall be the weighted average of the sales price for the shares as reported on the stock exchanges on which the company’s shares are quoted for the six-month period preceding the publication of the new rating by two independent rating

agencies. If, as previously described, the SVS determines that the shares are not actively traded on a stock exchange, the price shall be the book value calculated as described above.

There is no legal precedent as to whether a shareholder that has voted both for and against a proposal (such as the depositary) may exercise withdrawal rights with respect to the shares voted against the proposal. As such, there is doubt as to whether holders of ADRs who have not surrendered their ADRs and withdrawn common shares on or before the fifth business day prior to the shareholder meeting will be able to exercise withdrawal rights either directly or through the depositary with respect to the shares represented by ADRs. Under the provisions of the deposit agreement the depositary will not exercise these withdrawal rights.

#### *Registration and Transfers*

The *Depósito Central de Valores*, or the DCV, acts as Lan Airlines' registration agent. In the case of jointly owned common shares, an attorney-in-fact must be appointed to represent the joint owners in dealings with us.

#### **Material Contracts**

In 2005, we entered into Amendment No.2 and Amendment No.3 to the purchase agreement entered into in 1998 with Airbus SAS (formerly known as Airbus Industrie) for acquisition of 32 Airbus A320 family aircraft to be delivered in 2006, 2007 and 2008. These Amendments provide us with the option of purchasing 15 additional aircraft in the future. First deliveries will take place during August 2006, with four A319 aircraft and will continue during September 2006 with four more A319 aircraft. The estimated gross value of the Airbus aircraft for which we have firm commitments to take delivery under the Amendments is approximately US\$960 million.

In 2005 and 2006 we also agreed to purchase a total of 15 Boeing 767-300ER passenger and freighter aircraft, of which one passenger and two freighter aircraft had already been delivered through May 2006. Delivery of the remaining aircraft is scheduled to take place between June 2006 and 2008. We have the option to convert some of the orders from the passenger version to the freighter version or vice versa with certain anticipation. The estimated gross value (at list prices) of the Boeing aircraft for which we have firm commitments to take delivery under these contracts is approximately US\$1.1 billion.

For more information, see "Information on the Company—Fleet—Fleet Leasing and Financing Arrangements" under Item 4.

#### **Foreign Investment and Exchange Controls in Chile**

The Central Bank of Chile is responsible, among other things, for monetary policies and exchange controls in Chile. Equity investments, including investments in shares of stock by persons who are non-Chilean residents, are generally subject to various exchange control regulations restricting the repatriation of their investments and the earnings thereon.

On April 16, 2001, the Central Bank of Chile agreed that, effective April 19, 2001:

- prior foreign exchange restrictions would be eliminated; and
- a new Compendium of Foreign Exchange Regulations (*Compendio de Normas de Cambios Internacionales*) would be applied.

The main objective of these amendments, as declared by the Central Bank of Chile, is to facilitate movement of capital in and out of Chile and to encourage foreign investment.



In connection with the change in policy, the Central Bank of Chile eliminated the following restrictions:

- a reserve requirement with the Central Bank of Chile for a period of one year (this mandatory reserve was imposed on foreign loans and funds brought into Chile to purchase shares other than those acquired in the establishment of a new company or in the capital increase of the issuing company; the reserve requirement was gradually decreased from 30% of the proposed investment to 0%);
- the requirement of prior approval by the Central Bank of Chile for certain operations;
- mandatory return of foreign currencies to Chile; and
- mandatory conversion of foreign currencies into Chilean pesos.

Under the new regulations, only the following limitations apply to these operations:

- the Central Bank of Chile must be provided with information related to certain operations; and
- certain operations must be conducted with the Formal Exchange Market.

The Central Bank of Chile also eliminated Chapter XXVI of the Compendium of Foreign Exchange Regulations, which regulated the establishment of an ADR facility by a Chilean company. Pursuant to the new rules, it is no longer necessary to seek the Central Bank of Chile's prior approval in order to establish an ADR facility nor to enter into a foreign investment contract with the Central Bank of Chile. The establishment of an ADR facility is now regarded as an ordinary foreign investment, and simply requires that the Central Bank of Chile be informed of the transaction pursuant to Chapter XIV of the Compendium of Foreign Exchange Regulations and that the transaction be conducted exclusively through the Formal Exchange Market.

According to Chapter XIV of the Compendium of Foreign Exchange Regulations, if the funds to purchase the common shares underlying the ADSs are brought into Chile, the depositary, on behalf of foreign investors, must deliver to the entity of the Formal Exchange Market participating in the transaction an annex providing information about the transaction, together with a letter instructing such participant to deliver the foreign currency or the peso equivalent thereof, on or before the date on which the foreign currency is brought into Chile. If foreign investors do not bring the funds to purchase the common shares underlying the ADSs into Chile, the depositary, on behalf of the foreign investors, must provide the same information to the Central Bank of Chile directly or through an entity of the Formal Exchange Market within 10 days following the date on which the payment was made. Repatriation of amounts received with respect to deposited common shares or common shares withdrawn from deposit on surrender of ADRs (including amounts received as cash dividends and proceeds from the sale in Chile of the underlying common shares and any rights arising from them) must be made through the Formal Exchange Market. The entity of the Formal Exchange Market participating in the repatriation must provide certain information to the Central Bank of Chile on the next banking business day. In the event the payments are made outside of Chile, foreign investors must provide the relevant information to the Central Bank of Chile directly through an entity of the Formal Exchange Market within ten days following the date on which the payment was made.

Under Chapter XIV of the Compendium of the Foreign Exchange Regulations of the Central Bank of Chile, payments and remittances of funds from Chile are governed by the rules in effect at the time payment or remittance is made. Therefore, any change made to Chilean laws and regulations after the date hereof may affect foreign investors who have acquired ADSs. We cannot assure you that new regulations of the Central Bank of Chile or legislative changes to the current foreign exchange control regime in Chile will not affect our ability to remit foreign currency to make the relevant payments. For example, until June 26, 1998, the Compendium of Foreign Exchange Regulations required foreign investors acquiring shares or securities in Chile to maintain a mandatory reserve for one year in the form of an *encaje*, a non-interest bearing U.S. deposit with the Central Bank of Chile in an amount equal to 30% of the proposed investment. Alternatively, foreign investors could satisfy the reserve requirement by paying the Central Bank of Chile a non-refundable amount determined based on the amount that such investors would have had to deposit. On June 26, 1998, the mandatory reserve was reduced to 10%, and on September 17, 1998, it was reduced to 0%. Despite this reduction in the *encaje*, the Central Bank of Chile may reinstate the reserve at any time in an amount up to 40% of the proposed investment, and we cannot guarantee that the Central Bank of Chile will not do so. However, under current Chilean law, any reinstatement would apply only to those investments for which proceeds have been made available to foreign investors subsequent to the time of such reinstatement.

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The ADSs representing common shares of Lan Airlines offered under our November 6, 1997 initial public offering are subject to our Foreign Investment Contract, which guarantees ADS investors under our initial public offering access to the Formal Exchange Market to convert amounts from Chilean pesos into U.S. dollars and repatriate amounts received with respect to deposited common shares or common shares withdrawn from deposit or surrender of ADRs (including amounts received as cash dividends and proceeds from the sale in Chile of the underlying common shares and any rights arising from them). The guarantee of access to the Formal Exchange Market under the Foreign Investment Contract would be extended to the participants in an ADS offering if the following requirements are met:

- the funds to purchase the common shares underlying the ADSs are brought into Chile and converted into Chilean pesos through the Formal Exchange Market;
- the purchase of the underlying common shares is made on a Chilean stock exchange; and
- within five business days from conversion of the funds into Chilean pesos, the Central Bank of Chile is informed that the conversion funds were used to purchase the underlying common shares.

The following is a summary of material provisions of the Foreign Investment Contract, a form of which was filed as an exhibit to the registration statement on Form F-1 (File No. 333-7750) that we filed on October 10, 1997 in connection with our November 6, 1997 offering. This summary is not complete and is qualified in its entirety by reference to Chapter XXVI and the Foreign Investment Contract.

Under Chapter XXVI and the Foreign Investment Contract, the Central Bank of Chile agreed to grant to the depositary, on behalf of ADR holders, and to any investor not residing or domiciled in Chile who withdraws common shares upon surrender of ADRs, access to the Formal Exchange Market to convert Chilean pesos into U.S. dollars (and to remit those dollars outside Chile) in respect of common shares represented by ADSs or withdrawn shares, including amounts received as:

- cash dividends;
- proceeds from the sale in Chile of withdrawn shares or from shares distributed as a result of a liquidation, merger or consolidation of Lan Airlines (subject to receipt by the Central Bank of Chile of a certificate from the holder of the withdrawn shares or the distributed shares (or from an institution authorized by the Central Bank of Chile) that the holder's residence and domicile are outside of Chile, and a certificate from a Chilean stock exchange (or from a brokerage or securities firm established in Chile) that the withdrawn shares or the distributed shares were sold on a Chilean stock exchange);
- proceeds from the sale in Chile of preemptive rights to subscribe for additional common shares;
- proceeds from the liquidation, merger or consolidation of Lan Airlines;
- proceeds from the sale in Chile of common shares received as a dividend; and
- other distributions, including those in respect of any recapitalization resulting from holding common shares represented by ADSs or withdrawn shares.

Chapter XXVI provides that access to the Formal Exchange Market in connection with dividend payments is conditioned on our certifying to the Central Bank of Chile that a dividend payment has been made and that any applicable tax has been withheld. We agreed to provide this certification. Chapter XXVI also provides that access to the Formal Exchange Market in connection with the sale of withdrawn shares, or distribution on them, is conditioned upon receipt by the Central Bank of Chile of a certification by the depositary or custodian, as the case may be, that the common shares have been withdrawn in exchange for delivery of the appropriate ADRs and receipt of a waiver of the benefit of the Foreign Investment Contract with respect to them (except in connection with the proposed sale of the common shares) until the withdrawn shares are redeposited.

Chapter XXVI and the Foreign Investment Contract provide that a person who brings foreign currency into Chile to purchase common shares pursuant to the Foreign Investment Contract must convert that foreign currency into Chilean pesos on the date of entry into Chile, and must invest in common shares within five banking business days in order to receive the benefits of the Foreign Investment Contract. If a person does not invest in common shares within that period, that person can access the Formal Exchange Market to

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reacquire foreign currency, provided that the request is presented to the Central Bank of Chile within seven banking business days of the initial conversion into pesos. Common shares acquired as described above may be deposited in exchange for ADRs and will receive the benefits of the Foreign Investment Contract, subject to:

- receipt by the Central Bank of Chile of a certificate from the depositary that the common shares have been deposited and that the related ADRs have been issued; and
- receipt by the custodian of a declaration from the person making the deposit waiving the benefits of the Foreign Investment Contract with respect to the deposited common shares.

Access to the Formal Exchange Market under any of the circumstances described above is not automatic. Pursuant to Chapter XXVI, such access required approval of the Central Bank of Chile based on a request presented through a banking institution established in Chile. The Foreign Investment Contract provides that if the Central Bank of Chile has not acted on the request within seven banking days, the request is deemed approved.

Under current Chilean law, the Foreign Investment Contract cannot be changed unilaterally by the Central Bank of Chile. No assurance can be given, however, that additional Chilean restrictions applicable to the holders of ADRs, the disposition of underlying common shares or the repatriation of proceeds from their disposition will not be imposed in the future, nor can there be any assessment of the duration of impact of any restrictions that might be imposed.

### **Voting Rights**

Holders of our common shares may instruct the depositary to vote the shares underlying their ADRs. If we ask holders for instructions, the depositary will notify such holders of the upcoming vote and arrange to deliver our voting materials to such holders. The materials will describe the matters to be voted on and explain how holders may instruct the depositary to vote the shares or other deposited securities underlying their ADSs as they direct by a specified date. For instructions to be valid, the depositary must receive them on or before the date specified. The depositary will try, as far as practical, subject to Chilean law and the provisions of our by-laws, to vote or to have its agents vote the shares or other deposited securities as holders instruct. Otherwise, holders will not be able to exercise their right to vote unless they withdraw the shares. However, holders may not know about the meeting far enough in advance to withdraw the shares. We will use our best efforts to request that the depositary notify holders of upcoming votes and ask for their instructions.

If the depositary does not receive voting instructions from a holder by the specified date, it will consider such holder to have authorized and directed it to give a discretionary proxy to a person designated by our board of directors to vote the number of deposited securities represented by such holder's ADSs. The depositary will give a discretionary proxy in those circumstances to vote on all questions to be voted upon unless we notify the depositary that:

- we do not wish to receive a discretionary proxy;
- we think there is substantial shareholder opposition to the particular question; or
- we think the particular question would have an adverse impact on our shareholders.

The depositary will only vote or attempt to vote as such holder instructs or as described above.

We cannot assure holders that they receive the voting materials in time to ensure that they can instruct the depositary to vote their shares. This means that holders may not be able to exercise their right to vote and there may be nothing they can do if their shares are not voted as they requested.

### **Exchange Rates**

Prior to 1989, Chilean law permitted the purchase and sale of foreign exchange only in those cases explicitly authorized by the Central Bank of Chile. The Central Bank Act liberalized the rules that govern the

ability to buy and sell foreign currency. The Central Bank Act empowers the Central Bank of Chile to determine that certain purchases and sales of foreign currency specified by law must be carried out exclusively in the Formal Exchange Market, which is made up of the banks and other entities authorized by the Central Bank of Chile. All payments and distributions with respect to the ADSs must be conducted exclusively in the Formal Exchange Market.

For purposes of the operation of the Formal Exchange Market, the Central Bank of Chile sets a reference exchange rate (*dólar acuerdo*). The Central Bank of Chile resets the reference exchange rate monthly, taking internal and external inflation into account, and adjusts the reference exchange rate daily to reflect variations in parities between the Chilean peso, the U.S. dollar, the Japanese yen and the European euro.

The observed exchange rate (*dólar observado*) is the average exchange rate at which transactions were actually carried out in the Formal Exchange Market on a particular day, as certified by the Central Bank of Chile on the next banking day.

Prior to September 3, 1999, the Central Bank of Chile was authorized to buy or sell dollars in the Formal Exchange Market to maintain the observed exchange rate within a specified range above or below the reference exchange rate. On September 3, 1999, the Central Bank of Chile eliminated the exchange band. As a result, the Central Bank of Chile may buy and sell foreign exchange in the Formal Exchange Market in order to maintain the observed exchange rate at a level the Central Bank of Chile determines.

Purchases and sales of foreign exchange may be effected outside the Formal Exchange Market through the Informal Exchange Market (*Mercado Cambiario Informal*) established by the Central Bank in 1990. There are no limits on the extent to which the rate of exchange in the Informal Exchange Market can fluctuate above or below the observed exchange rate.

Although our results of operations have not been significantly affected by fluctuations in the exchange rates between the peso and the U.S. dollar because our functional currency is the U.S. dollar, we are exposed to foreign exchange losses and gains due to exchange rate fluctuations. Even though the majority of our revenues are denominated in or pegged to the U.S. dollar, the Chilean government's economic policies affecting foreign exchange and future fluctuations in the value of the peso against the U.S. dollar could adversely affect our results of operations and an investor's return on an investment in ADSs.

## **Chilean Taxation**

The following discussion relates to Chilean income tax laws presently in force, including Ruling No. 324 of January 29, 1990 of the Chilean Internal Revenue Service and other applicable regulations and rulings in effect on the date of this prospectus, all of which are subject to change. The discussion summarizes the principal Chilean income tax consequences of an investment in the ADSs or common shares by a person who is neither domiciled in, nor a resident of, Chile or by a legal entity that is not organized under the laws of Chile and does not have a permanent establishment located in Chile (such an individual or entity is referred to herein as a Foreign Holder). For purposes of Chilean tax law, an individual holder is a resident of Chile if such person has resided in Chile for more than six consecutive months in one calendar year or for a total of six months, whether consecutive or not, in two consecutive tax years. The discussion is not intended as tax advice to any particular investor, which can be rendered only in light of that investor's particular tax situation. PROSPECTIVE PURCHASERS SHOULD CONSULT THEIR TAX ADVISERS ABOUT THE CHILEAN TAX CONSEQUENCES TO THEM OF THE PURCHASE, OWNERSHIP AND DISPOSITION OF ADSs OR SHARES.

Under Chilean law, provisions contained in statutes such as tax rates applicable to foreign investors, the computation of taxable income for Chilean purposes and the manner in which Chilean taxes are imposed and collected may only be amended by another statute. In addition, the Chilean tax authorities enact rulings and regulations of either general or specific application and interpret the provisions of Chilean tax law. Chilean tax may not be assessed retroactively against taxpayers who act in good faith relying on such rulings,

regulations and interpretations, but Chilean tax authorities may change these rulings, regulations and interpretations prospectively. There is no income tax treaty in force between Chile and the United States.

#### *Cash Dividends and Other Distributions.*

Cash dividends we pay with respect to the ADSs or common shares held by a Foreign Holder will be subject to a 35% Chilean withholding tax, which we withhold and pay over to the Chilean tax authorities and which we refer to as the Withholding Tax. A credit against the Withholding Tax is available based on the level of corporate income tax we actually pay on the income to be distributed (referred to herein as the First Category Tax); however, this credit does not reduce the Withholding Tax on a one-for-one basis because it also increases the base on which the Withholding Tax is imposed. If we register net income but taxable losses, no credit against the Withholding Tax will be available. In addition, if we distribute less than all of our distributable income, the credit for First Category Tax we pay is proportionately reduced. Presently, the First Category Tax rate is 17%. In general, the example below illustrates the effective Chilean Withholding Tax burden on a cash dividend received by a Foreign Holder, assuming a Withholding Tax rate of 35%, an effective First Category Tax rate of 17% the actual payment of such First Category Tax at that 17% rate and a distribution of 30% of the consolidated net income of the Company after payment of the First Category Tax:

The Company's taxable income	100.00
First Category Tax (17% of Ch\$100)	(17)
Net distributable income	83.00
Dividend distributed (30% of net distributable income)	24.9
Withholding Tax (35% of the sum of Ch\$24.9 dividend plus Ch\$5.1 First Category Tax paid)	(10.5)
Credit for 30% of First Category Tax	5.1
Net tax withheld	(5.4)
Net dividend received	19.5
Effective dividend withholding rate	21.69%

In general, the effective dividend Withholding Tax rate, after giving effect to the credit for the First Category Tax, can be calculated using the following formula:

$$\frac{(\text{Withholding Tax rate}) - (\text{First Category Tax effective rate})}{1 - (\text{First Category Tax effective rate})}$$

Under Chilean income tax law, dividends generally are assumed to have been paid out of our oldest retained profits for purposes of determining the level of First Category Tax that we paid. The effective rate of Withholding Tax to be imposed on dividends we pay will vary depending upon the amount of First Category Tax we paid on the earnings to which the dividends are attributed. The effective withholding tax rate for dividends attributed to earnings from 1991 until 2001, for which the First Category Tax rate was 15%, will be 23.5%. For 2002, the First Category Tax rate was 16.0%, which results in an effective rate of 22.62%. In 2003, the First Category Tax rate was 16.5%, which results in an effective rate of 22.16%, and from 2004 onwards, the First Category Tax rate is 17%, which results in an effective rate of Withholding Tax of 21.69%.

For dividends attributable to our profits during years when the First Category Tax was 10% (before 1991), the effective rate will be 27.8%. However, whether the First Category Tax is 10%, 15%, 16%, 16.5% or 17%, the effective overall combined tax rate imposed on our distributed profits will be 35%. In the event that profits from previous years are not sufficient to cover a particular dividend, and the dividend is attributable to the current year, we will generally withhold tax from the dividend at the full 35% rate. If the withholding is determined to be excessive taking into account First Category Tax, holders may file for a refund.

Dividend distributions made in property would be subject to the same Chilean tax rules as cash dividends based on the fair market value of such property. Stock dividends and the distribution of preemptive rights are not subject to Chilean taxation.

### *Capital Gains*

Gain from the sale or other disposition by a Foreign Holder of ADRs evidencing ADSs outside Chile will not be subject to Chilean taxation. The deposit and withdrawal of common shares in exchange for ADRs will not be subject to any Chilean taxes.

Gain recognized on a sale or exchange of common shares (as distinguished from sales or exchanges of ADRs evidencing ADSs representing such common shares) may be subject to both the First Category Tax and the Withholding Tax (the former being creditable against the latter) if:

- the Foreign Holder has held the common shares for less than one year since exchanging ADSs for the Shares;
- the Foreign Holder acquired and disposed of the common shares in the ordinary course of its business or as a habitual trader of shares; or
- the Foreign Holder and the purchaser of the common shares are “related parties” within the meaning of Article 17, Number 8, of the Chilean Income Tax Law.

In all other cases, gain on the disposition of common shares will be subject only to a capital gains tax which is assessed at the same rate as the First Category Tax (currently imposed at a rate of 17%). Gain recognized in the transfer of common shares that have a high presence in the stock exchange, however, is not subject to capital gains tax in Chile, provided that the common shares are transferred in a local stock exchange, in other authorized stock exchanges or within the process of a public tender of common shares governed by the Securities Market Law. The common shares must also have been acquired either in a stock exchange, within the process of a public tender of common shares governed by the Securities Market Law, in an initial public offer of common shares resulting from the formation of a corporation or a capital increase of the same, or in an exchange of convertible bonds. Shares are considered to have a high presence in the stock exchange when they:

- are registered in the Securities Registry;
- are registered in a Chilean Stock exchange; and
- have an adjusted presence equal to or above 25%.

To calculate the adjusted presence of a particular share, the aforementioned regulation first requires a determination of the number of days in which the operations regarding the stock exceeded, in Chilean pesos, the equivalent of 200 Unidades de Fomento (approximately US\$70,000 as of May 31, 2006) within the previous 180 business days of the stock market. That number must then be divided by 180, multiplied by 100, and expressed in a percentage value. This tax regime does not apply if the transaction involves an amount of shares that would allow the acquirer to take control of the publicly traded corporation, in which case the ordinary tax regime referred to in the previous paragraph will apply, unless the transfer is part of a tender offer governed by the Securities Market Law or the transfer is done on a Chilean stock exchange, without substantially exceeding the market price.

Capital gains obtained in the sale of shares that are publicly traded and have a high presence in a stock exchange are also exempt from capital gains tax in Chile when the sale is made by “foreign institutional investors” such as mutual funds and pension funds, provided that the sale is made in a stock exchange or in accordance with the provisions of the Securities Market Law, or in any other form authorized by the SVS. To qualify as a foreign institutional investor, an entity must be formed outside of Chile, not have a domicile in Chile, and must be at least one of the following:

- an investment fund that offers its common shares or quotas publicly in a country with investment grade public debt, according to a classification performed by an international risk classification entity registered with the SVS;
- an investment fund registered with a regulatory agency or authority from a country with investment grade public debt, according to a classification performed by an international risk classification entity registered with the SVS, provided that its investments in Chile constitute less than 30% of the share value of the fund, including deeds issued abroad representing Chilean securities, such as ADRs of Chilean companies;

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- an investment fund whose investments in Chile represent less than 30% of the share value of the fund, including deeds issued abroad representing Chilean securities, such as ADRs of Chilean companies, provided that not more than 10% of the share value of the fund is directly or indirectly owned by Chilean residents;
- a pension fund that is formed exclusively by natural persons that receive pensions out of an accumulated capital in the fund;
- a Foreign Capital Investment Fund, as defined in Law No. 18,657; or
- any other foreign institutional investor that complies with the requirements set forth in general regulations for each category of investor or prior information from the SVS and the Chilean tax authority, the *Servicio de Impuestos Internos*, or the SII.

The foreign institutional investor must not directly or indirectly participate in the control of the corporations issuing the shares it invests in, nor possess or participate in 10% or more of the capital or the profits of such corporations.

Another requirement for the exemption is that the foreign institutional investor must execute a written contract with a bank or a stock broker incorporated in Chile. In this contract, the bank or stock broker must undertake to execute purchase and sale orders, verify the applicability of the tax exemption and inform the SII of the investors it works with and the transactions it performs. Finally, the foreign institutional investor must register with the SII by means of a sworn statement issued by such bank or stock broker.

The tax basis of common shares received in exchange for ADRs will be the acquisition value of the common shares on the date of exchange. The valuation procedure set forth in the deposit agreement, which values common shares which are being exchanged at the highest price at which they trade on the Santiago Stock Exchange on the date of the exchange, will determine the acquisition value for this purpose. Consequently, the surrender of ADRs for common shares and the immediate sale of the common shares for the value established under the Deposit Agreement will not generate a capital gain subject to taxation in Chile.

The exercise of preemptive rights relating to the common shares will not be subject to Chilean taxation. Any gain on the sale of preemptive rights relating to the common shares will be subject to both the First Category Tax and the Withholding Tax (the former being creditable against the latter).

### *Other Chilean Taxes*

There are no Chilean inheritance, gift or succession taxes applicable to the ownership, transfer or disposition of ADSs by a Foreign Holder, but such taxes generally will apply to the transfer at death or by gift of the common shares by a Foreign Holder. There are no Chilean stamp, issue, registration or similar taxes or duties payable by Foreign Holders of ADSs or common shares.

### *Withholding Tax Certificates*

Upon request, we will provide to Foreign Holders appropriate documentation evidencing the payment of the Chilean Withholding Tax (net of the applicable First Category Tax).

## **United States Federal Income Tax Considerations**

The following is a summary of certain U.S. federal income tax considerations that are likely to be relevant to the purchase, ownership and disposition of our common shares and ADSs by a beneficial owner that is a citizen or resident of the United States or a U.S. domestic corporation or that otherwise will be subject to U.S. federal income taxation on a net income basis in respect of such common shares or ADSs. For purposes of this discussion, we refer to these owners of common shares and ADSs as U.S. Holders. This summary is not a comprehensive discussion of all of the tax considerations that may be relevant to your decision to purchase ADSs or common shares. In particular, this discussion is directed only to U.S. Holders that will hold ADSs or common shares as capital assets and it does not address any special United States tax

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consequences that may be applicable to U.S. Holders that are subject to special treatment under the United States Internal Revenue Code of 1986, as amended, commonly referred to as the “Code”, such as banks, brokers or dealers in securities or currencies, traders in securities electing to mark to market, financial institutions, life insurance companies, tax exempt entities, or holders that own or are treated as owning 10% or more of our voting common shares, persons holding common shares or ADSs as part of a hedging or conversion transaction or a straddle, or persons whose functional currency is not the U.S. dollar. Prospective purchasers are advised to satisfy themselves as to the overall U.S. federal, state and local tax consequences of their ownership of ADRs and the underlying common shares by consulting their own tax advisers.

The statements of United States tax laws set out below are based on the laws in force as of the date hereof and may be subject to changes in United States law occurring after that date, including changes that may have retroactive effect.

### *ADRs*

In general, if you are a U.S. Holder of ADRs evidencing our ADSs, you will be treated, for U.S. federal income tax purposes, as the beneficial owner of the underlying common shares that are represented by those ADSs and evidenced by those ADRs.

### *Taxation of Dividends*

If you are a U.S. Holder, distributions of cash or property (other than common stock, if any, distributed pro rata to all of our shareholders, including holders of ADSs) paid out of our current or accumulated earnings and our profits (as determined for United States federal income tax purposes) with respect to common shares or ADSs, including the net amount of the Chilean Withholding Tax withheld on the distribution (after taking into account the credit for the First Category Tax), will be includible in your gross income as ordinary income on the day on which you receive the dividends, in the case of common shares, or the date the depositary receives the dividends, in the case of common shares represented by ADSs, and will not be eligible for the dividends-received deduction allowed to corporations under the Code. If you are a U.S. Holder, dividends paid in pesos generally will be includible in your income in a U.S. dollar amount calculated by reference to the exchange rate in effect on the day you receive the dividends, in the case of common shares, or the date the depositary receives the dividends, in the case of common shares represented by ADSs. U.S. Holders should consult their own tax advisers regarding the treatment of foreign currency gain or loss, if any, on any pesos received which are converted into U.S. dollars after they are received. To the extent that the amount of any distribution exceeds our current and accumulated earnings and profits as determined for U.S. federal income tax purposes, a U.S. Holder’s pro rata share of such excess amounts will be treated first as a nontaxable return of capital to the extent of such U.S. Holder’s tax basis in the common shares or ADSs and, thereafter, as capital gain.

Subject to certain exceptions for short-term and hedged positions, the U.S. dollar amount of dividends received by an individual prior to January 1, 2011 with respect to the ADSs will be subject to taxation at a maximum rate of 15% if the dividends are “qualified dividends”. Dividends paid on the ADSs will be treated as qualified dividends if:

- the ADSs are readily tradable on an established securities market in the United States; and
- we were not, in the year prior to the year in which the dividend was paid, and are not, in the year in which the dividend is paid, a passive foreign investment company (or “PFIC”).

The ADSs are listed on the New York Stock Exchange, and will qualify as readily tradable on an established securities market in the United States so long as they are so listed. Moreover, based on our audited financial statements and relevant market and shareholder data, we believe that we were not treated as a PFIC, for U.S. federal income tax purposes with respect to our 2004 or 2005 taxable year. In addition, based on our audited financial statements and our current expectations regarding the value and nature of our assets, the sources and nature of our income, and relevant market and shareholder data, we do not anticipate becoming a PFIC for our 2006 taxable year. Based on existing guidance, it is not clear whether dividends received with respect to the common shares will be treated as qualified dividends, because the common shares are not



themselves listed on a U.S. exchange. In addition, the U.S. Treasury has announced its intention to promulgate rules pursuant to which U.S. holders of ADSs or common shares and intermediaries through whom such securities are held will be permitted to rely on certifications from issuers to establish that dividends are treated as qualified dividends. Because such procedures have not yet been issued, it is not clear whether we will be able to comply with them. Holders should consult their own tax advisers regarding the availability of the reduced dividend tax rate in light of their own particular circumstances.

Subject to generally applicable limitations and conditions under the Code, Chilean Withholding Tax withheld from dividends (after taking into account the credit for the First Category Tax, when it is available) will be treated as a foreign income tax eligible for credit against a U.S. Holder's U.S. federal income tax liability. If the amount of Chilean Withholding Tax initially withheld from a dividend is determined to be excessive, however (as described above under "Taxation—Chilean Taxation—Cash Dividends and Other Distributions"), the excess tax will not be creditable. For purposes of calculating the foreign tax credit, dividends paid on the common shares will generally constitute foreign source "passive income." U.S. Holders are not allowed foreign tax credits for withholding taxes imposed in respect of certain short-term or hedged positions in securities and may not be allowed foreign tax credits in respect of arrangements in which their expected economic profit is insubstantial. U.S. Holders should consult their own advisers concerning the implications of these rules in light of their particular circumstances.

U.S. Holders that receive distributions of additional common shares or rights to subscribe for common shares as part of a pro rata distribution to all our shareholders generally will not be subject to U.S. federal income tax in respect of the distributions.

A holder of ADSs or common shares that is a foreign corporation or a non-resident alien individual generally will not be subject to U.S. federal income or withholding tax on dividends received on ADSs or common shares, unless that income is effectively connected with the conduct by the Non-U.S. Holder of a trade or business in the United States.

#### *Taxation of Capital Gains or Losses*

If you realize gain or loss on the sale, exchange or other disposition of ADSs or common shares, that gain or loss will be capital gain or loss and generally will be long-term capital gain or loss if the ADS or common shares have been held for more than one year. Long-term capital gain realized by a U.S. Holder that is an individual generally is subject to a maximum tax rate of 15%. The deductibility of capital losses is subject to significant limitations.

Any gain or loss a U.S. Holder realizes on such a sale, exchange, or other disposition will generally be treated as U.S. source income or loss for U.S. foreign tax credit purposes. Consequently, in the case of a disposition of common shares (which, unlike a disposition of ADSs, would be taxable in Chile), a U.S. Holder generally would not be able to utilize foreign tax credits in respect of any Chilean tax imposed on the disposition (see "Taxation—Chilean Taxation—Capital Gains") unless the U.S. Holder has other income from foreign sources, in the appropriate category, for purposes of the foreign tax credit limitation rules. U.S. Holders should consult their own tax advisers regarding the application of the foreign tax credit limitation rules to their investment in, and disposition of, the ADSs and common shares.

Deposits and withdrawals of common shares by U.S. Holders in exchange for ADSs will not result in the realization of gain or loss for U.S. federal income tax purposes.

A holder of ADSs or common shares that is a foreign corporation or a non-resident alien individual generally will not be subject to U.S. federal income tax on a gain from the sale or other disposition of ADSs or common shares unless:

- the gain is effectively connected with the conduct of a trade or business within the United States, or

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- in the case of a gain realized by a holder that is an individual, the holder is present in the United States for 183 days or more in the taxable year of the disposition, and certain other conditions are satisfied.

### *Backup Withholding and Information Reporting*

Dividends paid on, and proceeds from the sale or other disposition of, the ADSs or common shares to a U.S. Holder generally may be subject to the information reporting requirements of the Code and may be subject to backup withholding unless the U.S. Holder provides an accurate taxpayer identification number and makes any other required certification or otherwise establishes an exemption. Backup withholding is not an additional tax. The amount of any backup withholding from a payment to a U.S. Holder will be allowed as a credit against the U.S. Holder's U.S. federal income tax liability and may entitle the U.S. Holder to a refund, provided that certain required information is furnished to the U.S. Internal Revenue Service.

A holder that is a foreign corporation or a non-resident alien individual may be required to comply with certification and identification procedures in order to establish its exemption from information reporting and backup withholding.

HOLDERS OF ADSs OR COMMON SHARES SHOULD CONSULT THEIR OWN TAX ADVISERS AS TO THE CHILEAN, U.S. OR OTHER TAX CONSEQUENCES OF THE PURCHASE, OWNERSHIP AND DISPOSITION OF ADSs OR COMMON SHARES, INCLUDING, IN PARTICULAR, THE EFFECT OF ANY FOREIGN, STATE OR LOCAL TAX LAWS.

### **Documents on Display**

We are subject to the information requirements of the Securities Exchange Act of 1934, as amended. In accordance with these requirements, we file reports, including annual reports on Form 20-F and other information with the SEC. These materials, including this annual report and the exhibits hereto, may be inspected and copied at the SEC's public reference rooms in Washington, D.C. Please call the SEC at 1-800-SEC-0330 for further information on the public reference rooms. In addition, some of our SEC filings, including those filed on and after November 4, 2002, are also available to the public through the SEC's website at [www.sec.gov](http://www.sec.gov).

## **ITEM 11. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

We face market risk exposure in three main areas:

- jet fuel price fluctuations;
- interest rate fluctuations; and
- exchange rate fluctuations.

We periodically review our exposure to risks arising from these fluctuations and determine at the level of senior management how to hedge these risks. We manage jet fuel price fluctuation risk through hedging transactions in the foreign derivatives market. We have also entered into hedging transactions with respect to interest rates and exchange rates in order to control our exposure to fluctuations in interest rates and the relative values of foreign currencies, respectively. We do not enter into forward contracts, swaps, collars or other derivatives for speculative purposes. The derivative instruments we hold are not leveraged, and we hold them only for purposes of offsetting market exposure.

### *Risk of Fluctuations in Jet Fuel Prices*

Jet fuel price fluctuations are largely dependent on supply and demand for crude oil in the world, OPEC decisions, refinery capacities, stock levels of crude oil and global political factors. In order to minimize the risk of jet fuel price fluctuations, we enter into hedging contracts in the jet fuel market or in the West

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Texas Intermediate, or WTI, market. Our decision to enter into these contracts, whether in the jet fuel market or in the WTI market, depends on the relative price of each commodity at the trade date.

We enter into swap contracts to hedge our exposure to fluctuations in fuel prices that allow us to fix the price of future jet fuel purchases. We also employ call options, which allow us to purchase fuel at a predetermined price. Additionally, we use combinations of call and put options that allow us to establish a range of prices, also known as a costless collar, in which the price that we pay for jet fuel is limited by a minimum and maximum price.

Under costless collar contracts, for any price that is above the predetermined ceiling price, we receive the difference between the market price and the ceiling price for a given quantity of jet fuel. For any price below the predetermined floor price, we pay the difference between the market price and the floor price. Pursuant to swap contracts, we pay or receive, depending on the case, the difference between the agreed fixed price and the floating market price calculated on the notional amounts of such contracts.

We are exposed to fuel hedging transaction losses if the other parties to our hedging contracts fail to perform. To manage this credit risk, we select counterparties based on their credit ratings and limit our exposure to each counterparty based on defined guidelines. We also monitor our relative market position with each counterparty periodically.

During 2003, 2004, and 2005, we entered into a mix of costless collar contracts, call option contracts and jet fuel swap contracts with investment banks and other financial entities for notional fuel purchases of 134.0 million gallons, 111.4 million gallons, and 175.4 million gallons, respectively (which represent 46.0%, 36.2% and 51.8%, respectively, of our total fuel consumption). The result of these contracts was a gain of approximately US\$12.3 million in 2003, a gain of approximately US\$46.5 million in 2004, and a gain of approximately US\$51.5 million in 2005. The fair value of our outstanding swap contracts was estimated at positive US\$15.4 million at December 31, 2003, at positive US\$15.9 million at December 31, 2004, and at positive US\$11.2 million at December 31, 2005. Based on market jet fuel price data as of December 30, 2005, we estimate that a one cent increase or decrease in jet fuel prices would have a positive or negative impact, respectively, on our results of US\$2.7 million for 2006.

Gains and losses on the hedging contracts referred to above are recognized as a non-operating item (on the miscellaneous net line) in our income statement when the underlying fuel being hedged is consumed. Premiums paid to enter into hedging contracts are recorded as prepaid expenses and are amortized and included in our results of operations over the respective contract periods.

According to Chilean GAAP, the positive fair value of these jet fuel derivatives is reflected in the balance sheet as other long-term assets and the negative fair value is reflected in other long-term liabilities.

### *Risk of Fluctuations in Interest Rates*

The major interest rate risk we face is a rise in the London Interbank Offered Rate, or LIBOR, because we had, as of December 31, 2005, US\$747.9 million in principal amount of LIBOR-based interest-bearing debt outstanding. As of March 31, 2006, we had US\$812.8 million in principal amount of LIBOR-based interest-bearing debt outstanding. As of December 31, 2005, approximately 12.5% of our banking debt (including our long-term, short-term and dollar-denominated debt) was exposed to interest rate risks.

In May 2001, we entered into six swap contracts in order to hedge our floating rate-exposure on US\$329 million of our debt. Pursuant to these contracts, we pay or receive, depending on the case, the difference between the agreed fixed rate and the floating rate, calculated on the notional amount of each contract. The fair value of these contracts as of December 31, 2005 was estimated to be at negative US\$5.0 million and the fair value as of March 31, 2006 was estimated to be at negative US\$2.5 million.

According to Chilean GAAP, the positive fair value of these interest rate swaps is reflected in the balance sheet as other long-term assets and the negative fair value of these agreements is reflected as other long-term liabilities.

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During 2002, we entered into a treasury rate-lock contract in order to hedge our exposure to changes in the five-year treasury rate before entering into a US\$40.0 million securitization tranche of credit card receivables in the United States. For more information, see “Operating and Financial Review and Prospects—Credit Card Receivables Securitization” under Item 4. The gains or losses on such contracts are recognized as a component of interest expense in our financial statements amortized over the life of the securitization. We settled this operation the day that we completed the securitization, and it involved a total payment of US\$3.6 million, of which we recognized US\$530,000 as interest expense in 2005. There was no fair value associated with this operation as of December 31, 2005 since we had already settled the operation.

During the period of 2003 through 2005, we entered into interest rate call option contracts for a notional amount of US\$274 million. These contracts allow us to limit our exposure to LIBOR at a predetermined value. The total premium paid amounted to US\$11.3 million. As of December 31, 2005, the fair value of these contracts was estimated to be at negative US\$5.5 million and as of March 31, 2006, the fair value has estimated to be at negative US\$0.2 million.

The utilization of the aforementioned hedging instruments, combined with fixed interest rate financing for two Boeing 767-300F aircraft with delivery in 2001 and two Boeing 767-300F aircraft with delivery in 2005, has enabled us to limit the impact that interest rate fluctuation could have on 87.5% of our interest bearing debt.

As of December 2005, the average interest of all of our outstanding interest-bearing debt rate is 5.1%

The following table summarizes our principal payment obligations on our interest-bearing debt and capital leases as of December 31, 2005 and the related average interest rates. The average interest rates for U.S. dollar liabilities are calculated based on the prevailing interest rate on December 31, 2005 for each loan.

Liabilities	Principal payment obligations by year of expected maturity <sup>(1)</sup>						
	Average interest rate <sup>(2)</sup>	2006	2007	2008	2009	2010	Thereafter
U.S. dollars	5.1%	93.2	100.7	96.0	98.3	90.6	318.2

<sup>(1)</sup> At cost, which approximates market value.

<sup>(2)</sup> Average interest rate means the average prevailing interest rate on December 31, 2005 on our debt.

### **Risk of Variation in Foreign Currency Exchange Rates**

During 2005 approximately 80% of our operating revenues and approximately 73% of our operating expenses were denominated in U.S. dollars, creating a partial natural hedge with each other. However, because we conduct business in local currencies in several countries, we face the risk of variation in foreign currency exchange rates. For more information, see Note 24 to our consolidated financial statements. A depreciation of the Chilean peso, the Brazilian real, the Argentine peso, the Mexican nuevo peso, the Peruvian nuevo sol or the European euro against the U.S. dollar could have a material adverse effect on us because we have revenues and receivables denominated in those currencies. As a part of our risk management policy, we regularly monitor our exposure to variations in the exchange rates of these different currencies. In order to reduce the impact of foreign exchange rate fluctuations, we enter into foreign exchange hedging contracts from time to time. As of December 31, 2005 we had no foreign exchange hedging contracts aimed at hedging our cash flow or balance sheet.

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Our foreign currency exchange exposure pertaining to our balance sheet as of December 31, 2005 was as follows:

	US dollars	% of total	Chilean pesos	% of total	Other currencies	% of total	Total
Current assets	454,368	78.44%	67,286	11.62%	57,571	9.94%	579,225
Other assets	1,545,175	98.64%	12,595	0.80%	8,788	0.56%	1,566,558
Total assets	1,999,543	93.19%	79,881	3.72%	66,359	3.09%	2,145,783
Current liabilities	598,562	87.45%	55,746	8.15%	30,107	4.40%	684,415
Long-term liabilities	942,574	98.67%	5,346	0.56%	7,362	0.77%	955,282
Total liabilities and shareholders' equity	2,047,231	95.40%	61,084	2.85%	37,469	1.75%	2,145,784

**ITEM 12. DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES**

Not applicable.

**PART II****ITEM 13. DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES**

Not applicable.

**ITEM 14. MATERIAL MODIFICATIONS TO THE RIGHTS OF SECURITY HOLDERS AND USE OF PROCEEDS**

Not applicable.

**ITEM 15. CONTROLS AND PROCEDURES**

We carried out an evaluation under the supervision and with the participation of our management, including our chief executive officer and chief financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of December 31, 2005. There are inherent limitations to the effectiveness of any system of disclosure controls and procedures, including the possibility of human error and the circumvention or overriding of the controls and procedures. Accordingly, even effective disclosure controls and procedures can only provide reasonable assurance of achieving their control objectives. Based upon our evaluation, our chief executive officer and chief financial officer concluded that the disclosure controls and procedures, as of December 31, 2005, were effective to provide reasonable assurance that information required to be disclosed by us in the reports we file or submit under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the applicable rules and forms, and that it is accumulated and communicated to our management including our Chief Executive Officer and Chief Financial Officer as appropriate to allow timely decisions regarding required disclosure.

There has been no change in our internal control over financial reporting during 2005 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**ITEM 16. RESERVED**

**ITEM 16A. AUDIT COMMITTEE FINANCIAL EXPERT**

Our Board of Directors has designated Mr. José Cox Donoso an independent director as required by the Chilean Corporation Law and applicable New York Stock Exchange listing standards, as an “audit committee financial expert” within the meaning of this Item 16A. See “Item 6. Directors, Senior Management and Employees–Directors.”

**ITEM 16B. CODE OF ETHICS**

We have adopted a code of ethics, as defined in Item 16B of Form 20-F under the Exchange Act. Our code of ethics applies to our senior management, including our chief executive officer, our chief financial officer and our chief accounting officer, as well as to other employees. Upon request, in writing or orally, by telephone or by e-mail, to the following address: Lan Airlines S.A., Investor Relations Department, attention: Investor Relations, Av. Presidente Riesco 5711, Piso 20, Comuna Las Condes, Santiago, Chile, telephone (56-2) 565-3947, email: [investor.relations@lan.com](mailto:investor.relations@lan.com), we will provide any person with a copy of our code of ethics without charge. If we amend the provisions of our code of ethics that apply to our senior management or to other persons performing similar functions, or if we grant any waiver of such provisions, we will disclose such amendment or waiver on our website at [www.lan.com](http://www.lan.com).

**ITEM 16C. PRINCIPAL ACCOUNTANT FEES AND SERVICES***Audit and Non-Audit Fees*

The following table sets forth the fees billed to us by our independent auditors, PricewaterhouseCoopers, during the fiscal years ended December 31, 2004 and 2005:

	Year ended December 31,		
	2003	2004	2005
(in thousands of US dollars)			
Audit fees	502.5	554.2	717.8
Audit-related fees	0.0	69.6	36.1
Tax fees	24.2	23.1	80.7
Other fees	3.9	0.0	1.9
Total fees	530.6	646.9	836.5

Audit fees in the above table are the aggregate fees billed by PricewaterhouseCoopers in connection with the audit of our annual consolidated financial statements, as well as the review of other filings. The increase in such fees in 2005 arise mostly from the incorporation of LanArgentina in our audit review.

Audit-related fees in the above table are fees billed by PricewaterhouseCoopers mainly for due diligence services related to potential acquisitions and mergers.

Tax fees in the above table are fees billed by PricewaterhouseCoopers for tax advice and tax planning services.

Other fees in the above table are fees billed by PricewaterhouseCoopers primarily for salary surveys and human resources-related services.

*Board of Directors' Committee Pre-Approval Policies and Procedures*

Since January 2004, LAN complies with the SEC regulation regarding what type of additional services PriceWaterhouseCoopers is authorized to offer to us. In addition to this, our Board of Directors' Committee decided to automatically authorize those accepted services for an amount of up to 10% of the fees charged by the auditing firm, and for an amount of up to 50% when adding all those services together. In case the amount is larger than that, then it will need the approval of the Board of Directors' Committee.

**ITEM 16D. EXEMPTIONS FROM THE LISTING STANDARDS FOR AUDIT COMMITTEES**

Not applicable.

**ITEM 16E. PURCHASE OF EQUITY SECURITIES BY THE ISSUER AND AFFILIATED PURCHASERS**

Neither we nor any affiliated purchaser has engaged in share repurchases during the year ended December 31, 2005.

**PART III****ITEM 17. FINANCIAL STATEMENTS**

Our financial statements have been prepared in accordance with Item 18 hereof.

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### ITEM 18. FINANCIAL STATEMENTS

See pages F-1 through F-55, incorporated herein by reference. The following is an index of the financial statements in the referenced pages.

#### Consolidated Financial Statements for Lan Chile S.A. and Subsidiaries

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<a href="#">Consolidated Statement of Income for the years ended December 31, 2003, 2004 and 2005</a>	F-5
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<a href="#">Notes to Consolidated Financial Statements at December 31, 2005</a>	F-8

### ITEM 19. EXHIBITS

Documents filed as exhibits to this annual report:

<u>Exhibit No.</u>	<u>Description</u>
1.1	By-laws of Lan Airlines S.A. (incorporated by reference to our annual report on Form 20-F (File No. 001-14728) filed on June 30, 2005).
2.1	Amended and Restated Deposit Agreement among LanChile, The Bank of New York, and all registered holders from time to time of any American Depositary Receipts, including the form of American Depositary Receipt (incorporated by reference to our annual report on Form 20-F (File No. 001-14728) filed on June 14, 2004).
2.2	Foreign Investment Contract among the Central Bank of Chile, LanChile and Citibank, N.A., as depositary, relating to the foreign exchange treatment of holders of ADSs (incorporated by reference to our annual report on Form 20-F (File No. 001-14728) filed on June 14, 2004).
2.3	Foreign Investment Contract Assignment Agreement among the Central Bank of Chile, LanChile, Citibank N.A., as assignor, and The Bank of New York, as assignee, relating to the foreign exchange treatment of holders of ADSs (incorporated by reference to our annual report on Form 20-F (File No. 001-14728) filed on June 14, 2004).
2.4	Right of First Refusal Agreement among Inversiones Santa Cecilia S.A., Bancard S.A., Inversiones Costa Verde, S.A., Inmobiliaria e Inversiones Asturias S.A., Inversiones Aéreas CGP S.A., Inversiones Aéreas CGP DOS S.A. (incorporated by reference to our annual report on Form 20-F (File No. 001-14728) filed on June 14, 2004).
2.5	Supplement to Right of First Refusal Agreement among Inversiones Costa Verde Limitada y Compañía en Comandita por Acciones, Inversiones Santa Cecilia S.A., Axxion S.A., Inversiones Aéreas CGP S.A. and Inversiones Aéreas CGP DOS S.A. (incorporated by reference to our annual report on Form 20-F (File No. 001-14728) filed on June 30, 2005).



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2.6	Joint Action Agreement among Inversiones Costa Verde Limitada y Compañía en Comandita por Acciones, Inversiones Santa Cecilia S.A., and Axxion S.A. (incorporated by reference to our annual report on Form 20-F (File No. 001-14728) filed on June 30, 2005).
4.1	Purchase Agreements between Lan Chile S.A. and Airbus Industrie relating to Airbus A320-family aircraft and Airbus A340 series aircraft (incorporated by reference to our annual report on Form 20-F (File No. 001-14728) filed on June 24, 2001 and portions of which have been omitted pursuant to a request for confidential treatment).
4.1.1	Amendments No. 2 and 3, Letter Agreements No. 1, 2, 3, 4, 5, 6A, 6B, 7, 8 to Amendment No. 2, Side Letters to Amendment No. 2 and Side Letter to Amendment No. 3 to the Second A320F Purchase Agreement dated March 20, 1998 as amended and restated, between Lan Airlines S.A. (formerly known as Lan Chile S.A.) and Airbus S.A.S. (as successor to Airbus Industrie).*
4.2	Purchase Agreement No. 2126 between Lan Chile S.A. and The Boeing Company as amended and supplemented, relating to Model 767-316ER, Model 767-38EF, and Model 767-316F Aircraft (incorporated by reference to our amended annual report on Form 20-F (File No. 001-14728) filed on December 21, 2004 and portions of which have been omitted pursuant to a request for confidential treatment).
4.2.1	Supplemental Agreements No. 16, 17, 18, 19, 20, 21 and 22 to the Purchase Agreement No. 2126 between Lan Airlines (formerly known as Lan Chile S.A.) and The Boeing Company, relating to Model 767-316ER, Model 767-38EF, and Model 767-316F Aircraft, dated as of January 30, 1998.*
8.1	List of subsidiaries of the Company.
12.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
12.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
13.1	Certifications of Chief Financial Officer and Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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\* These documents are being submitted separately to the Securities and Exchange Commission pursuant to a request for confidentiality treatment.

\* These documents are being submitted separately to the Securities and Exchange Commission pursuant to a request for confidentiality treatment.

**SIGNATURES**

The registrant hereby certifies that it meets all of the requirements for filing on Form 20-F and that it has duly caused and authorized the undersigned to sign this annual report on its behalf.

Lan Airlines S.A.

/s/ ALEJANDRO DE LA FUENTE GOIC

Name: Alejandro de la Fuente Goic

Title: Chief Financial Officer

Date: June 30, 2006

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LAN AIRLINES S.A.

Consolidated financial statements

December 31, 2005

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- Ch\$ - Chilean pesos
- US\$ - United States dollars
- ThUS\$ - Thousands of United States dollars
- UF - The UF is a Chilean inflation-indexed, peso-denominated monetary unit which is set daily in advance based on the previous month's inflation rate



REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of  
Lan Airlines S.A.

**We have audited the accompanying consolidated balance sheets of Lan Airlines S.A. (formerly Lan Chile S.A.) and its subsidiaries (the “Company”) as of December 31, 2005 and 2004 and the related consolidated statements of income and of cash flows for each of the three years in the period ended December 31, 2005, all expressed in thousands of United States dollars. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.**

**We conducted our audits in accordance with generally accepted auditing standards in both Chile and the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.**

**In our opinion, based on our audits, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Lan Airlines S.A. and its subsidiaries at December 31, 2005 and 2004 and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2005, in conformity with accounting principles generally accepted in Chile.**

**Accounting principles generally accepted in Chile vary in certain significant respects from accounting principles generally accepted in the United States of America. Information relating to the nature and effect of such differences is presented in Note 26 to the consolidated financial statements.**

Santiago, Chile  
March 24, 2006

LAN AIRLINES S.A. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

	<u>At December 31,</u>	
	<u>2005</u>	<u>2004</u>
	<u>(In thousands of US\$)</u>	
<b>ASSETS</b>		
<b>CURRENT ASSETS</b>		
Cash	11,733	11,620
Time deposits	34,519	179,715
Marketable securities (Note 3)	112,983	113,290
Trade accounts receivable and other, net (Note 4)	312,232	242,824
Notes and accounts receivable from related companies (Note 14)	899	2,978
Inventories (Note 5)	37,283	35,323
Prepaid and recoverable taxes	24,307	18,153
Prepaid expenses (Note 6)	24,278	23,140
Deferred income tax assets (Note 13)	7,670	10,085
Other current assets (Note 7)	13,321	15,274
<b>Total current assets</b>	<b>579,225</b>	<b>652,402</b>
PROPERTY AND EQUIPMENT (net) (Note 8)	1,252,270	978,974
<b>OTHER ASSETS</b>		
Investments in related companies (Note 9)	1,649	1,843
Goodwill (Note 9)	44,751	42,470
Notes and accounts receivable from related companies (Note 14)	10,252	1,069
Long-term accounts receivable	9,756	9,851
Advances for purchases of aircraft and other deposits (Note 10)	223,288	109,943
Other (Note 11)	24,592	32,724
<b>Total other assets</b>	<b>314,288</b>	<b>197,900</b>
<b>Total assets</b>	<b>2,145,783</b>	<b>1,829,276</b>

*The accompanying Notes 1 to 26 form an integral part of these consolidated financial statements.*

LAN AIRLINES S.A. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

	<u>At December 31,</u>	
	<u>2005</u>	<u>2004</u>
	<u>(In thousands of US\$)</u>	
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>CURRENT LIABILITIES</b>		
Current of short-term loans from financial institutions	11,666	—
Current portion of long-term loans from financial institutions (Note 15)	53,104	34,098
Current portion of long-term leasing obligations (Note 17)	33,870	38,817
Securitization obligation (Note 16)	11,817	12,908
Dividends payable	35,000	—
Accounts payable	236,212	224,046
Notes and accounts payable to related companies (Note 14)	327	281
Air traffic liability and other unearned income	175,580	128,235
Other current liabilities (Note 12)	126,839	143,680
Total current liabilities	684,415	582,065
<b>LONG-TERM LIABILITIES</b>		
Loans from financial institutions (Note 15)	521,974	317,233
Securitization obligation (Note 16)	31,549	43,366
Other creditors	27,755	83,497
Notes and accounts payable to related companies (Note 14)	—	446
Provisions (Note 12)	117,277	100,810
Obligations under capital leases (Note 17)	161,151	192,301
Deferred income tax liabilities (Note 13)	95,576	71,303
Total long-term liabilities	955,282	808,956
<b>MINORITY INTEREST</b>	3,373	3,698
<b>COMMITMENTS AND CONTINGENCIES (Note 22)</b>		
<b>SHAREHOLDERS' EQUITY (Note 18)</b>		
Common stock (318,909,090 shares)	134,303	134,303
Reserves	2,620	2,620
Retained earnings	365,790	297,634
Total shareholders' equity	502,713	434,557
Total liabilities and shareholders' equity	2,145,783	1,829,276

*The accompanying Notes 1 to 26 form an integral part of these consolidated financial statements.*

LAN AIRLINES S.A. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF INCOME

	For the years ended December 31,		
	2005	2004	2003
	(In thousands of US\$)		
<b>REVENUES</b>			
Passenger	1,460,584	1,169,049	918,370
Cargo	910,453	799,656	602,038
Other (Note 19)	135,316	124,240	118,392
Total operating revenues (Note 24)	<u>2,506,353</u>	<u>2,092,945</u>	<u>1,638,800</u>
<b>EXPENSES</b>			
Wages and benefits (Note 20)	(371,596)	(292,823)	(240,924)
Aircraft fuel	(642,696)	(414,539)	(259,566)
Commissions to agents	(345,387)	(291,693)	(223,974)
Depreciation and amortization	(80,456)	(77,443)	(72,631)
Passenger services	(53,176)	(44,992)	(36,206)
Aircraft rentals	(148,202)	(132,425)	(139,138)
Aircraft maintenance	(132,198)	(120,818)	(97,862)
Other rentals and landing fees	(301,544)	(287,842)	(258,495)
Other operating expenses	(289,462)	(258,270)	(198,287)
Total operating expenses	<u>(2,364,717)</u>	<u>(1,920,845)</u>	<u>(1,527,083)</u>
Operating income	141,636	172,100	111,717
<b>OTHER INCOME AND EXPENSES</b>			
Interest income	12,426	10,830	6,277
Interest expense	(39,191)	(36,459)	(39,350)
Other income (expense) - net (Note 21)	58,234	45,162	24,123
Total other income (expense)	<u>31,469</u>	<u>19,533</u>	<u>(8,950)</u>
Income before minority interest	173,105	191,633	102,767
Minority interest	1,754	212	(870)
Income before income taxes	174,859	191,845	101,897
Income taxes (Note 13)	(28,258)	(28,293)	(18,342)
<b>NET INCOME</b>	<u>146,601</u>	<u>163,552</u>	<u>83,555</u>

*The accompanying Notes 1 to 26 form an integral part of these consolidated financial statements.*

LAN AIRLINES S.A. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

	For the years ended December 31,		
	2005	2004	2003
	(In thousands of US\$)		
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>			
Collection of trade accounts receivable	2,213,947	1,989,671	1,663,149
Interest income	11,679	9,596	3,885
Other income received	65,139	54,171	13,821
Payments to suppliers and personnel	(1,938,117)	(1,638,208)	(1,377,257)
Interest paid	(36,630)	(37,117)	(44,522)
Income tax paid	(1,782)	(194)	(337)
Other expenses paid	(1,724)	(1,806)	(3,984)
Value-added tax and similar payments	(35,575)	(29,360)	(19,021)
Net cash provided by operating activities	276,937	346,753	235,734
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>			
Loans obtained	268,501	2,817	11,088
Other loans from related companies	—	—	10,417
Dividend payments	(43,536)	(81,577)	(49,101)
Loans repaid	(35,481)	(43,725)	(75,178)
Other	(11,596)	(12,283)	(14,276)
Net cash provided by (used in) financing activities	177,888	(134,768)	(117,050)
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>			
Acquisitions of property and equipment	(592,410)	(126,911)	(64,756)
Proceeds from sales of property and equipment	1,694	2,098	7,612
Sale of financial instruments and other investments	77,981	51,725	8,693
Other investments	(5,624)	(939)	(829)
Investments in financial instruments	(38,978)	(76,800)	(68,946)
Other	(3,085)	(2,042)	(2,127)
Net cash (used in) investing activities	(560,422)	(152,869)	(120,353)
<b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>	(105,597)	59,116	(1,669)
<b>CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR</b>	<b>216,868</b>	<b>157,752</b>	<b>159,421</b>
<b>CASH AND CASH EQUIVALENTS AT END OF YEAR</b>	<b>111,271</b>	<b>216,868</b>	<b>157,752</b>



LAN AIRLINES S.A. AND SUBSIDIARIES

RECONCILIATION OF NET INCOME TO NET CASH

PROVIDED BY OPERATING ACTIVITIES

	<u>For the years ended December 31,</u>		
	<u>2005</u>	<u>2004</u>	<u>2003</u>
	<u>(In thousands of US\$)</u>		
NET INCOME FOR THE YEAR	146,601	163,552	83,555
ADJUSTMENTS TO RECONCILE NET INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES			
Depreciation	73,969	68,132	67,750
Gain on sales of investments	—	422	(122)
Gain on sales and retirements of property and equipment	(1,511)	(1,289)	(4,017)
Proportional share of results of equity method investments	(583)	249	676
Amortization of goodwill	3,216	3,134	3,267
Minority interest	(1,754)	(212)	870
Write-offs and provisions	10,827	13,671	7,202
Foreign exchange losses/(gains)	(6,270)	(2,437)	(12,055)
Other	106	(257)	(256)
CHANGES IN ASSETS AND LIABILITIES			
(Increase) decrease in accounts receivable - trade	(26,083)	103,262	7,474
(Increase) decrease in inventories	(9,526)	(8,967)	1,958
(Increase) decrease in other assets	(29,649)	(603)	40,730
(Decrease) increase in accounts payable	99,843	(11,083)	23,745
(Decrease) increase in other liabilities	17,751	19,179	14,957
Net cash provided by operating activities	<u>276,937</u>	<u>346,753</u>	<u>235,734</u>

*The accompanying Notes 1 to 26 form an integral part of these consolidated financial statements.*

LAN AIRLINES S.A. AND SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

AT DECEMBER 31, 2005

NOTE 1 - THE COMPANY

Lan Airlines S.A., formerly Lan Chile S.A., (“Lan” or the “Company”) is the largest domestic and international passenger/cargo air carrier in Chile and one of the largest airlines in Latin America. Together with its code-share arrangements and affiliated airlines. Through its own operations and code-share arrangements, the LAN Alliance serves 15 destinations in Chile, 11 destinations in Peru, 9 destinations in Argentina, 2 in Ecuador, 20 destinations in other Latin American countries, 25 in North America, 10 destinations in Europe and 4 in the South Pacific. Lan has alliances with American Airlines, Alaska Airlines, AeroMexico, British Airways, Iberia, Lufthansa Cargo, Mexicana, Qantas and TAM and is an official member of the oneworld™ global alliance.

The Company is a Chilean corporation (“Sociedad Anónima Abierta”) whose common stock is listed on the Santiago Stock Exchange, the Chilean Electronic Stock Exchange, and the Valparaíso Stock Exchange and whose American Depositary Receipts are traded on the New York Stock Exchange. Accordingly, the Company is subject to the regulations of both the Chilean Superintendency of Securities and Insurance (the “Superintendency”) and the U.S. Securities and Exchange Commission.

NOTE 2 - SUMMARY OF ACCOUNTING POLICIES

*a) Presentation*

The consolidated financial statements have been prepared in accordance with generally accepted accounting principles in Chile, which include the accounting standards of the Superintendency. The preparation of financial statements in accordance with generally accepted accounting principles in Chile (“Chilean GAAP”) requires management to make estimates and assumptions that affect the reported amounts and disclosures in the financial statements. Actual results could differ from those estimates.

The Company has issued its statutory consolidated financial statements in Spanish and in conformity with accounting principles generally accepted in Chile, which include certain notes and additional information required by the Superintendency for statutory purposes. Management believes that these additional notes and information are not essential for the complete understanding of the consolidated financial statements and, accordingly, these notes and additional information have been excluded from the accompanying financial statements.

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### *b) Consolidation*

The consolidated financial statements for the years 2005, 2004 and 2003 include the following subsidiaries:

	December 31		
	2005	2004	2003
Percentage of direct and indirect ownership:			
Lan Perú S.A.	70.00	70.00	70.00
Inversiones Lan S.A. and subsidiaries	99.71	99.71	99.71
Lan Cargo S.A. (formerly Lan Chile Cargo S.A.) and subsidiaries	99.89	99.87	99.85
Inmobiliaria Aeronáutica S.A.	100.00	100.00	100.00
Comercial Masterhouse S.A.	100.00	100.00	100.00
Sistemas de Distribución Amadeus Chile S.A.	100.00	100.00	100.00
Lan Courier S.A. and subsidiary	100.00	100.00	100.00
Lan Card S.A.	100.00	100.00	100.00
Lan Pax Group S.A. and subsidiaries	100.00	100.00	100.00
Lan Cargo Group S.A.	100.00	100.00	100.00
Línea Aérea Nacional Chile S.A.	100.00	100.00	100.00
Lan Chile Investments Limited and subsidiaries	100.00	100.00	100.00

The effects of significant transactions between the subsidiaries and subsidiaries with the holding company have been eliminated in the consolidation and the participation of minority shareholders is shown in these financial statements as minority interest in the Consolidated Balance Sheets and Consolidated Statements of Income.

### *c) Use of estimates*

The preparation of the consolidated financial statements requires the use of estimates and assumptions that affect the reported amounts of assets and liabilities, the reported amounts of revenues and expenses and the disclosure of contingent liabilities. Management makes its best estimate of the ultimate outcome for these items based on historical trends and other information available when the financial statements are prepared. Changes in estimates are recognized in accordance with the accounting rules for the estimate, which is typically in the period when new information becomes available to management. Areas where the nature of the estimate makes it reasonably possible that actual results could materially differ from amounts estimated include: impairment assessments on long-lived assets (including goodwill), inventory obsolescence, engine overhaul provisions, tax liabilities and the associated deferred tax effects, contingent liabilities and other liabilities.

### *d) Price-level restatements*

The financial statements of certain subsidiaries have been restated through the application of monetary correction rules in accordance with Chilean GAAP to show the effects of changes in the purchasing power of the Chilean peso, using indicators published by the National Institute of Statistics.

*e) Foreign currency transactions*

Lan Chile and certain subsidiaries are authorized to maintain their accounting records and prepare their financial statements in US dollars. Because the US dollar is the functional and reporting currency, assets and liabilities denominated in other currencies are remeasured to US dollars at the exchange rates prevailing on December 31 of each year except for inventory, property and equipment, other assets and air traffic liability, which are remeasured at historical exchange rates. Revenues and expenses are generally translated at the exchange rates on the dates of the transactions.

Foreign currency transaction gains and losses are included in the Consolidated Statements of Income in Other income (expense)—net. The Company recorded a net foreign currency gain of ThUS\$ 6,004, ThUS\$ 2,353, ThUS\$ 12,055 for the years ended 2005, 2004 and 2003, respectively.

*f) Time deposits*

Time deposits are stated at cost plus accrued interest at year-end.

*g) Marketable securities*

Marketable securities include investments in bonds and mutual funds. Bonds are stated at the lower of cost plus accrued interest or market value plus accrued interest and mutual funds are stated at market value based on year-end quoted values.

*h) Allowance for bad debts*

The Company maintains an allowance for bad debts based on an analysis of the aging of the outstanding balances as well as other relevant information. Other relevant information includes detailed analysis of our customers' payment history, an analysis of the current economic and commercial environment and all relevant available public information regarding our clients and the current business environment. Our policy for determining past due accounts focuses on the aging of the receivable balance and the different forms of payment used by the debtor. Receivable balances are written off against the allowance for bad debts once they are deemed uncollectible and all collection efforts and available legal measures have been exhausted.

*i) Inventories*

Inventories represent spare parts and materials that are expected to be consumed and used in third-party maintenance services within one year. No obsolescence reserve is recorded or deemed necessary and inventories are stated at the lower of cost (determined by the average cost method) or market.

*j) Other current assets*

Other current assets include primarily the fair value of hedged forecasted jet fuel derivative contracts in unrealized gain positions and restricted funds associated with aircraft leases.

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### *k) Property and equipment*

Property and equipment are stated at cost and are depreciated by the straight-line method to their estimated residual values based on the estimated useful lives of the assets. Aircraft and engines are depreciated based on estimated useful life ranging from 10 to 20 years and utilizing a salvage value based on a residual value percentage of the cost of the asset.

The residual values and basis of depreciation used for the principal asset classifications are:

<b>Asset classification</b>	<b>Residual Value (%)</b>	<b>Basis of depreciation</b>
Boeing 767-300 F aircraft	36	Useful life (15 years)
Boeing 767-300 ER aircraft	36	Useful life (15 years)
Boeing 737-200 ADV aircraft	15	Useful life (until December 31, 2008)
Boeing 767-200 ER aircraft	36	Useful life (15 years)
DC-8 61F	—	Useful life (until December 31, 2004)
Airbus A-320	20	Useful life (20 years)
Engines 767	36	Useful life (15 years)
Engines 737	15	Useful life (until December 31, 2008)
Engines Airbus A-320	20	Useful life (20 years)
Engines Airbus A-340	36	Useful life (15 years)
Rotating parts	20	Useful life (15 years)
Buildings	—	Useful life (10-50 years)
Communications and computer equipment	—	Useful life (5-10 years)
Furniture and office equipment	—	Useful life (3-10 years)

Property and equipment include the revaluation increment arising from the technical appraisals of certain assets carried out in prior years in accordance with instructions issued by the Superintendency.

Inventories of materials and spare parts, net of provisions for obsolescence, included under other fixed assets within Property and equipment, are stated at their average cost.

The Company has entered into capital lease agreements related to five aircraft and certain buildings and equipment which have bargain purchase options at the end of each contract. These assets are not the legal property of the Company, because it cannot dispose of them until the purchase option is exercised. The assets are recorded at their fair value on the date of the lease agreement, which is determined by discounting the amounts payable in installments and the purchase option at the interest rate implicit, or explicit, in the contract.

The corresponding leasing obligations are presented under long-term liabilities and under the current portion of long-term leasing obligations.

Disbursements for the development of internal use software are charged to the results of operations as incurred. External direct costs of materials and services rendered in developing an enterprise resource planning system (an SAP R/3 system) and interest costs incurred during development are capitalized. Payroll related costs were not significant and have been expensed. Training costs and data conversion costs are expensed as incurred.

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Impairment losses on long-lived assets used in operations are recorded when events and circumstances indicate that the assets may be impaired and the undiscounted future cash flows estimated to be generated by these assets are less than the assets' net book value. If an impairment occurs, the loss is measured by comparing the fair value of the asset to its carrying amount. Fair values are determined based on quoted market values, discounted cash flows or internal and external appraisals, as applicable.

Under Chilean GAAP, spare parts which are not anticipated to be consumed within the next 12 months are included in property, plant and equipment. Spare parts are not depreciated, irrespective of whether they are included in fixed assets or inventory and they are expensed upon their usage in maintenance. All spare parts are recorded at the lower of cost or market value.

Spare parts included in the Consolidated Balance Sheet are classified as follows:

	At December 31,		
	2005	2004	2003
	(In thousands of US\$)		
Inventories	34,789	32,070	31,100
Property and equipment	18,330	11,595	5,586
Total	53,119	43,665	36,686

### *l) Investments in related companies*

Investments in related companies are included in Other assets using the equity method when they represent between 20% and 50% of the voting stock of the investee, or when a Company has a significant influence in the operations of the investment. Accordingly, the Company's proportional share in the net income (or loss) of each investee is recognized on an accrual basis, after eliminating any unrealized profits or losses from transactions with the investees in Other income (expense)—net in the Consolidated Statements of Income.

### *m) Goodwill*

Under Chilean GAAP, effective January 1, 2004, Technical Bulletin N° 72 ("TB 72") requires the determination of goodwill and negative goodwill based on the fair value of the acquired company. Prior to January 1, 2004, goodwill included the excess of the purchase price of companies acquired over their net book value; negative goodwill was established when the net book value exceeded the purchase price of companies acquired. Goodwill and negative goodwill also arise from the purchase of investments accounted for by the equity method.

Goodwill and negative goodwill are amortized over 20 years considering the expected period of return of the investment. The Company evaluates the recoverability of goodwill on a periodic basis.

### *n) Sale leaseback*

Gains on sale leaseback transactions are deferred and recognized over the terms of the lease agreements.

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### *o) Air traffic liability and revenue recognition policy*

Passenger ticket sales are recorded as a current liability when sold as air traffic liability in the Consolidated Balance Sheets. Air traffic liability at December 31, 2005 and 2004 amounted to ThUS\$ 174,587 and ThUS\$ 127,252 respectively.

Passenger and cargo revenues are recognized when the transportation service is provided, which, in the case of passenger revenues reduces the air traffic liability. Commissions payable related to such unearned earnings are shown net of the air traffic liability. Other revenues include aircraft leases, courier, logistic and ground services, duty free sales, and storage and customs brokering. These other revenues are recognized when services are provided.

### *p) Aircraft and engine maintenance costs*

Minor unscheduled maintenance costs of owned and leased aircraft and engines are charged to income as incurred. Costs of major programmed maintenance are accrued based on the use of the aircraft and engines and are included in Other current liabilities and long-term Provisions in the Consolidated Balance Sheets. Such provisions are established based on the total flight hours of an aircraft.

### *q) Lease Aircraft Return Costs*

The majority of leased aircraft return costs are maintenance and overhaul costs, which are accounted for similarly to such costs for owned aircraft. The airframe and engine overhaul expenses associated with leased aircraft are accrued as part of our overhaul provision included in Other liabilities and reflected in provisions in the Consolidated Balance Sheet. Such provisions are based on the flight hours incurred by the leased aircraft and also take into consideration the lease terms and the date of incorporation of the aircraft into our fleet. The actual direct costs of physically returning the planes and related administration costs are expensed when incurred.

### *r) Deferred income tax*

Effective January 1, 2000, the effects of deferred income taxes arising from temporary differences between the basis of assets and liabilities for tax and financial statement purposes are recorded in accordance with Technical Bulletin No. 60 of the Chilean Institute of Accountants and based on the enacted income tax rate which will be in effect when the temporary differences reverse. The effects of deferred income taxes at January 1, 2000 which were not previously recorded are recognized in income beginning in 2000 as the temporary differences reverse.

In order to mitigate the effects of recording deferred income taxes that under the prior income tax accounting standard were not expected to be realized, Technical Bulletin No. 60 provided for a period of transition. Under this transition period, the full effect of using the liability method is not recorded in income at the same time the deferred taxes are recorded in the balance sheet. Under this transitional provision, a contra asset or liability account (“complementary accounts”) have been recorded offsetting the effects of the deferred tax assets and liabilities not recorded prior to January 1, 2000. Such complementary accounts are amortized to income over the estimated average reversal periods corresponding to underlying temporary differences to which the deferred tax asset or liability relates.

Deferred income tax assets are reduced by a valuation allowance if, based on the weight of available evidence, it is more likely than not that some portion or all of the deferred income tax assets will not be realized. The valuation allowance should be sufficient to reduce the deferred income tax asset to an amount that is more likely than not to be realized.

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### s) *Lan Pass awards and Lan Corporate*

The estimated incremental cost of providing free travel awards under the Lan Pass and Lan Corporate programs are accrued based on the accumulated kilometers for each passenger at the end of each year and by the conditions established by the program and are included in Other current liabilities in the Consolidated Balance Sheets.

### t) *Employee vacations*

The cost of employee vacations is recognized as an expense on an accrual basis as the vacations are earned by employees and are included in Other current liabilities in the Consolidated Balance Sheets.

### u) *Derivative instruments*

The Company enters into hedging contracts including interest rate swap agreements, interest rate cap agreements, forward exchange contracts, jet fuel swap agreements, and jet fuel options. The contracts are accounted for in accordance with Technical Bulletin No. 57, "Accounting for Derivative Contracts" ("TB 57") of the Chilean Institute of Accountants. Under TB 57 all derivative instruments are recognized on the balance sheet at their fair value. Derivative instruments are accounted for as follows:

#### *Hedge Forecasted transaction:*

The derivative instrument is stated at its fair value on the balance sheet and any change in the fair value is recognized on the balance sheet as an unrealized gain or loss in other assets, other liabilities, current or long term, as applicable. When the contract is settled, the unrealized gain or loss on the instrument is recognized in earnings in Other income (expense)—net in the Consolidated Statements of Income.

#### *Firm commitments hedging contracts:*

The hedged item and derivative instrument are measured at fair value on the balance sheet. Unrealized gains and losses are recorded in earnings in Other income (expense)—net in the Consolidated Statements of Income if the net effect is a loss and deferred and recognized when the contract is settled if it is a gain. The unrecognized gains associated with the derivative instrument are included in other liabilities, current or long term, as applicable.

### v) *Cash and cash equivalents*

The Company considers all short-term, highly-liquid investment securities with original maturities of three months or less to be cash equivalents for purposes of the Consolidated Statement of Cash Flows:

	At December 31,		
	2005	2004	2003
	(In thousands of US\$)		
Cash	11,733	11,620	4,988
Time deposits	34,519	179,715	128,950
Marketable securities (see Note 3)	65,019	25,533	23,814
Total	<u>111,271</u>	<u>216,868</u>	<u>157,752</u>



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Under Chilean GAAP, certain assets (specifically, bonds as of December 31, 2005 and 2004) are classified as marketable securities in the Consolidated Balance Sheet, but are not considered cash and cash equivalents for purposes of the statement of cash flows.

### w) *Capitalized interest*

Interest paid on borrowings used to acquire new aircraft is capitalized as an additional cost of the related assets until the aircraft is received. Interest is capitalized based on the Company's weighted-average interest rate on long-term debt, or if applicable, the interest rate related to specific borrowings. Interest capitalization ends when the property or equipment is ready for service or its intended use. The Company capitalized ThUS\$ 1,575 of interest in 2005 and no interest was capitalized for the years ended December 31, 2004 and 2003.

### x) *Advertising costs*

The Company expenses advertising costs as Other operating expenses in the period incurred. Advertising expense totaled ThUS\$ 19,490, ThUS\$ 15,607, and ThUS\$ 11,550 during 2005, 2004 and 2003, respectively.

### y) *Reclassifications*

Certain 2003 and 2004 amounts in the accompanying financial statements have been reclassified to conform to the 2005 presentation. The reclassifications had no material effect on the previously reported presentation of net income or shareholders' equity.

## NOTE 3 - MARKETABLE SECURITIES

Marketable securities include the following:

	<u>At December 31,</u>	
	<u>2005</u>	<u>2004</u>
	<u>(In thousands of US\$)</u>	
Bonds	47,964	87,757
Defined-term mutual funds	65,019	25,533
Total	<u>112,983</u>	<u>113,290</u>

Bonds recorded at December 31, 2005 are summarized as follows:

	<u>Date of</u>		<u>Interest rate</u> %	<u>At December 31, 2005</u>	
	<u>Purchase</u>	<u>Maturity</u>		<u>Carrying amount</u>	<u>Market value</u>
				<u>(In thousands of US\$)</u>	
Chilean bonds	06/15/2004	08/02/2006	7.89	17,385	22,451
Foreign bonds	06/28/2004	11/20/2006	9.37	30,579	33,922
Total				<u>47,964</u>	<u>56,373</u>

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**NOTE 4 - ACCOUNTS RECEIVABLE**

Accounts receivable are summarized as follows:

	<b>At December 31,</b>	
	<b>2005</b>	<b>2004</b>
	<b>(In thousands of US\$)</b>	
Accounts receivable - passenger services	63,905	46,258
Accounts receivable - cargo services	103,225	100,631
Other accounts receivable	145,102	95,935
Total	<u>312,232</u>	<u>242,824</u>

Accounts receivable are shown net of an allowance for bad debts of ThUS\$ 25,800 at December 31, 2005 and ThUS\$ 25,250 at December 31, 2004.

Other accounts receivable for the year ended December 31, 2004 include advances for aircraft purchases in the amount of ThUS\$ 62,682 which were previously recorded as long-term Advances for purchases of aircraft and other deposits.

**NOTE 5 - INVENTORIES**

Inventories are summarized as follows:

	<b>At December 31,</b>	
	<b>2005</b>	<b>2004</b>
	<b>(In thousands of US\$)</b>	
Spare parts and materials used for third party maintenance	34,789	32,070
Duty-free inventories	2,494	3,253
Total	<u>37,283</u>	<u>35,323</u>

**NOTE 6 - PREPAID EXPENSES**

Prepaid expenses include the following:

	<b>At December 31,</b>	
	<b>2005</b>	<b>2004</b>
	<b>(In thousands of US\$)</b>	
Prepaid insurance on aircraft	14,502	13,352
Prepaid rentals on aircraft and costs of receiving leased aircraft	4,139	3,748
Prepaid advertising services	204	383
Other	5,433	5,657
Total	<u>24,278</u>	<u>23,140</u>

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Costs of receiving aircraft include all costs incurred by the Company and its subsidiaries in order for them to be operational. Such costs are deferred and amortized to operating expenses over the term of the specified contract. Costs of returning leased aircraft, excluding maintenance and overhaul, are expensed as incurred.

### NOTE 7 - OTHER CURRENT ASSETS

Other current assets consist of the following:

	<u>At December 31,</u>	
	<u>2005</u>	<u>2004</u>
	<u>(In thousands of US\$)</u>	
Restricted funds associated with aircraft leases and purchases and other deposits	699	1,825
Fair value of derivative contracts	9,575	10,361
Other	3,047	3,088
Total	<u>13,321</u>	<u>15,274</u>

### NOTE 8 - PROPERTY AND EQUIPMENT AND FLEET COMPOSITION

#### *a) Property and equipment*

Property and equipment are summarized as follows:

	<u>At December 31,</u>	
	<u>2005</u>	<u>2004</u>
	<u>(In thousands of US\$)</u>	
Flight equipment:		
Boeing 767 aircraft under capital lease	369,103	439,678
Boeing 737 - 200ADV aircraft	48,368	49,968
Boeing 767 - 200ER aircraft	70,574	—
Boeing 767 - 300F freighter aircraft	459,034	274,546
Airbus A-319 aircraft	67,448	—
Airbus A-320 aircraft	142,469	142,469
DC-8 aircraft	—	1,433
Engines and rotating parts	226,385	170,463
Spare parts	18,330	11,595
Other	38,656	34,359
Land and buildings:		
Land	10,739	10,739
Buildings	61,953	57,438
Other installations	25,436	20,619
Construction in progress	9,454	7,329
Other fixed assets:		
Communication and computer equipment	90,678	78,426
Furniture and office equipment	14,935	14,587
Equipment under capital leases	31	688
Other	<u>42,387</u>	<u>39,526</u>
Property and equipment (gross)	1,695,980	1,353,863
Less: Accumulated depreciation	<u>(443,710)</u>	<u>(374,889)</u>
Property and equipment (net)	<u>1,252,270</u>	<u>978,974</u>

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On September 30, 2004, the Company sold its 100% interests in Condor Leasing LLC and Eagle Leasing LLC, who were the owners of 5 Boeing 767 aircraft (3 and 2, respectively). The capital lease agreement under which Lan Airlines S.A. leased these aircraft has remained unchanged. As a result of this, these aircraft retain their balance sheet classification under flight equipment; however, they are now under the caption flight equipment under capital lease. Long-term debt (with its related current portion) associated with these aircraft is included in Obligations under capital leases.

Included in property and equipment at December 31, 2005 and 2004, are ThUS\$ 369,134 and ThUS\$ 440,366 of equipment under capital leases with accumulated depreciation aggregating ThUS\$ 108,118 and ThUS\$ 141,876, respectively.

Depreciation expense for the years ended December 31, 2005, 2004 and 2003, amounted to ThUS\$ 73,969, ThUS\$ 68,132 and ThUS\$ 67,750, respectively.

The balance of spare parts is presented net of a provision for obsolescence amounting to ThUS\$ 12,853 at December 31, 2005 and ThUS\$ 12,788 at December 31, 2004.

In 2002, the Company entered into a sale-leaseback transaction. Under the arrangement, engines were sold for US\$ 13,000,000 and leased backed over a 7-year operating lease agreement. The gain on the sale of ThUS\$ 6,833 is being amortized over the term of the operating lease agreement.

### *b) Fleet composition*

At December 31, 2005, the fleet of the Company consists of 73 aircrafts, of which 28 aircrafts are owned by, or under capital lease to, the Company and 45 aircrafts are leased under operating leases.

Aircraft owned or under capital lease by the Company:

<b>Aircraft</b>	<b>Model</b>	<b>Use</b>	<b>2005</b>	<b>2004</b>
Boeing 737	200ADV	Passenger/Freight	10	11
Boeing 737	200ADV	Freight	1	1
Boeing 767	300ER	Passenger/Freight	3	3
Boeing 767	300F	Freight	7	5
Boeing 767 (*)	200ER	Passenger/Freight	1	1
Airbus A-319	100	Passenger/Freight	2	—
Airbus A-320	200	Passenger/Freight	4	4
DC-8	61-F	Freight	—	1
Total owned			<u>28</u>	<u>26</u>

(\*) Subleased to Aerovías de México S.A. under a 9-year contract beginning June 16, 1996. The sublease expired in the year 2005 and was extended until 2007.

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Leased aircraft under operating leases:

<b>Aircraft</b>	<b>Model</b>	<b>Use</b>	<b>2005</b>	<b>2004</b>
Boeing 767	300ER	Passenger/Freight	13	12
Boeing 767	300F	Freight	1	1
Boeing 737	200ADV	Passenger/Freight	11	7
Airbus A 319	100	Passenger/Freight	5	5
Airbus A 320	200	Passenger/Freight	11	10
Airbus A 340	300	Passenger/Freight	4	4
Total leased			<u>45</u>	<u>39</u>
Total owned and leased			<u>73</u>	<u>65</u>

## NOTE 9 - INVESTMENTS IN RELATED COMPANIES AND GOODWILL

### *a) Investments in related companies*

Investments in related companies accounted for by the equity method are summarized as follows:

<b>Company</b>	<b>Percentage of ownership</b>			<b>Book value of investment</b>		<b>Proportional Share of income (loss)</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>	<b>2005</b>	<b>2004</b>	<b>2005</b>	<b>2004</b>	<b>2003</b>
	<b>%</b>	<b>%</b>	<b>%</b>			<b>(In thousands of US\$)</b>		
Concesionaria Chucumata S.A.	16.70	16.70	16.70	117	345	160	83	70
CAE Entrenamiento de Vuelo Chile Ltda. (ExFTCC)	—	—	—	—	—	—	(35)	(446)
Lufthansa Lan Chile Technical Training S.A.	50.00	50.00	50.00	571	482	152	53	30
Austral Sociedad Concesionaria S.A.	20.00	20.00	20.00	879	952	173	90	17
Florida West International Airways Inc. <sup>(1)</sup>	25.00	25.00	25.00	—	—	79	(49)	158
Skypost. Inc. <sup>(3)</sup>	—	—	25.00	—	—	—	(136)	(139)
Choice Air Courier del Perú S.A.	50.00	50.00	50.00	82	64	19	(2)	(5)
Skynet London. Ltd. <sup>(2)</sup>	—	—	—	—	—	—	—	(29)
SkyBox Internacional de Venezuela <sup>(2)</sup>	—	—	—	—	—	—	—	(167)
SkyBox Soluciones Logísticas S.A. <sup>(2)</sup>	—	—	—	—	—	—	—	(46)
Skynet Worldwide Express of California L.C. <sup>(2)</sup>	—	—	—	—	—	—	—	(119)
Vimalcor S.A. <sup>(3)</sup>	—	—	—	—	—	—	101	—
Skyworld International Couriers S.A.	—	—	—	—	—	—	(226)	—
Skybox de Colombia Ltda. <sup>(3)</sup>	—	—	—	—	—	—	(128)	—
Total				<u>1,649</u>	<u>1,843</u>	<u>583</u>	<u>(249)</u>	<u>(676)</u>

<sup>(1)</sup> The Company has recorded a provision for investments in related companies with negative equity at year-end totaling ThUS\$ 128 at December 31, 2005 and ThUS\$ 207 at December 31, 2004 which is included in other current liabilities (See Note 12).

<sup>(2)</sup> During 2003, this entity was sold and the operations were dissolved.

<sup>(3)</sup> During 2004, this entity was sold and the operations were dissolved.

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### b) Goodwill and negative goodwill

The changes in Goodwill and negative goodwill during the years 2005 and 2004 were as follows:

<u>Company</u>	<u>Balance January 1, 2005</u>	<u>Additions and deductions (In thousands of US\$)</u>	<u>Amortization</u>	<u>Balance December 31, 2005</u>
Goodwill on purchase of:				
Lan Cargo S.A. (Ex Lan Chile Cargo S.A.)	22,624	—	(1,810)	20,814
Prime Airport Service Inc.	475	—	(35)	440
Mas Investment Limited	2,904	—	(180)	2,724
Air Cargo Limited	683	—	(43)	640
Promotora Aérea Latinoamericana S.A.	1,464	—	(84)	1,380
Inversiones Aéreas S.A. (purchase of interest in Lan Perú S.A.)	4,884	—	(294)	4,590
Aerolinhas Brasileiras S.A.	2,444	—	(144)	2,300
Skyworld International Couriers, Inc.	4,332	—	(254)	4,078
Lan Box, Inc.	2,008	—	(106)	1,902
SkyBox Services Corp.	748	—	(55)	693
Skyworld Internacional Courier S.A.	11	—	(11)	—
H.G.A. Rampas y Servicios A. de Guayaquil S.A.	38	—	(2)	36
H.G.A. Rampas del Ecuador S.A.	38	—	(2)	36
Inversora Cordillera S.A.	—	4,815	(182)	4,633
Aero 2000 S.A.	—	684	(24)	660
Total	42,653	5,499	(3,226)	44,926
Negative goodwill on purchase of:				
Choice Air Courier del Perú S.A	(75)	—	2	(73)
Americonsult de Guatemala S.A.	(108)	—	6	(102)
Total	(183)	—	8	(175)
Total	42,470	5,499	(3,218)	44,751

  

<u>Company</u>	<u>Balance January 1, 2004</u>	<u>Additions and deductions (In thousands of US\$)</u>	<u>Amortization</u>	<u>Balance December 31, 2004</u>
Goodwill on purchase of:				
Lan Cargo S.A. (Ex Lan Chile Cargo S.A.)	24,556	—	(1,932)	22,624
Prime Airport Service Inc.	510	—	(35)	475
Mas Investment Limited	3,084	—	(180)	2,904
Air Cargo Limited	726	—	(43)	683
Promotora Aérea Latinoamericana S.A.	1,548	—	(84)	1,464
Vimalcor S.A.	288	(276)	(12)	—
Inversiones Aéreas S.A. (purchase of interest in Lan Perú S.A.)	5,178	—	(294)	4,884
Aerolinhas Brasileiras S.A.	2,588	—	(144)	2,444
Skyworld International Couriers, Inc.	4,586	—	(254)	4,332
Lan Box, Inc.	1,302	809	(103)	2,008
Skyworld Internacional Courier S.A.	12	—	(1)	11
SkyBox Services Corp.	804	—	(56)	748
H.G.A. Rampas y Servicios A. de Guayaquil S.A.	40	—	(2)	38
H.G.A. Rampas del Ecuador S.A.	40	—	(2)	38
Total	45,262	533	(3,142)	42,653
Negative goodwill on purchase of:				
Choice Air Courier del Perú S.A.	(77)	—	2	(75)
Americonsult de Guatemala S.A.	(114)	—	6	(108)
Total	(191)	—	8	(183)
Total	45,071	533	(3,134)	42,470

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### *c) Acquisitions and other information*

#### LanLogistics, Corp.

During April 2004, the Company's indirect subsidiary LanLogistics Corp. acquired an additional 16% interest in its subsidiary Lan Box Inc. increasing its ownership to 96%. This acquisition was paid for through a service credit amounting to ThUS\$ 541 and the transfer of 25% of its indirect interest in Skypost Inc. This transaction generated goodwill amounting to ThUS\$ 809.

#### Mas Investment Limited (Bahamas)

During January 2003, Mas Investment Limited (Bahamas), a wholly-owned subsidiary of Lan Cargo Overseas Limited (a subsidiary of Lan Cargo S.A.), purchased 788,240 shares in Aerotransportes Mas de Carga S.A. for ThUS\$ 788, increasing its ownership interest from 25% to 39.51%. Mas Investment Limited (Bahamas) recorded goodwill amounting to ThUS\$ 191 as a result of this transaction.

In the same offering, Promotora Aérea Latinoamericana S.A., which is a consolidated subsidiary of Mas Investment Limited (Bahamas), took part in the share increase offering of the company Aerotransportes Mas de Carga S.A. in which it owns 75%. In order to maintain its ownership, it acquired 2,036,249 shares for ThUS\$ 2,250.

#### Lan Cargo Overseas Limited

On April 3, 2002, Lan Cargo Overseas Limited purchased 550,000 shares of Vimalcor S.A., which is incorporated in the Oriental Republic of Uruguay for ThUS\$ 400 representing a 50% ownership interest. During December 2004, the entire interest in Vimalcor S.A. was sold, generating a loss of ThUS\$ 307.

#### CAE Entrenamiento de Vuelo Chile Ltda. (formerly Fligh Training Center Chile S.A.)

During April 2004, Lan Airlines S.A., together with its subsidiary Lan Pax Group S.A., sold their interest's in CAE Entrenamiento de Vuelo Chile S.A. for ThUS\$ 1,877. This transaction generated a loss of ThUS\$ 27.

#### Lan Pax Group S.A.

On April 13, 2005 Lan Pax Group S.A. acquired 49% ownership and obtained control of Inversora Cordillera S.A. On April 14, 2005, the newly acquired and consolidated subsidiary Inversora Cordillera S.A. acquired 95% ownership of Aero 2000 S.A. In a separate transaction Lan Pax Group S.A. acquired an additional 2.45% of Aero 2000 S.A. These transactions were accounted for as purchases resulting in ThUS\$ 5,499 in goodwill allocated ThUS\$ 4,815 to Inversora Cordillera S.A. and ThUS\$ 684 to Aero 2000 S.A.

In November 2005, in a separate transaction, Lan Pax Group S.A. and Inversora Cordillera S.A., both consolidated subsidiaries of the Company, formed the entity Siventis S.A. with Lan Pax Group S.A. having 95% ownership and Inversora Cordillera S.A. having 5%. As of December 31, 2005 the capital for this entity had not been entirely contributed. Both companies are required to make capital contributions prior to 2008.

On December 23, 2005, Lan Pax group S.A. took part in the share increase offering of its consolidated subsidiary Inversora Cordillera S.A. It invested ThUS\$ 281 maintaining its current ownership percentage of 49%. No goodwill was recorded.

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Lan Cargo S.A.

On November 4, 2005, Lan Airlines S.A. acquired 15,000 shares from its affiliated Lan Cargo S.A. increasing its ownership interest from 99.86462% to 99.88875%.

### NOTE 10 - ADVANCES FOR PURCHASES OF AIRCRAFT AND OTHER DEPOSITS

Advances for purchases of aircraft and other deposits are summarized as follows:

	<u>At December 31,</u>	
	<u>2005</u>	<u>2004</u>
	<u>(In thousands of US\$)</u>	
Advances for purchases of Boeing 767 and lease of Airbus aircraft	211,204	100,631
Deposits on aircraft leases	9,037	7,281
Other deposits	3,047	2,031
Total	<u>223,288</u>	<u>109,943</u>

### NOTE 11 - OTHER ASSETS

Other assets are summarized as follows:

	<u>At December 31,</u>	
	<u>2005</u>	<u>2004</u>
	<u>(In thousands of US\$)</u>	
Unrealized losses on derivative contracts <sup>(1)</sup>	16,066	23,670
Deposits related to aircraft to be purchased or leased and others	8,526	9,054
Total	<u>24,592</u>	<u>32,724</u>

<sup>(1)</sup> The corresponding fair value derivative contract liability is recorded in Other current liabilities and in Other creditors long term.

### NOTE 12 - OTHER LIABILITIES AND PROVISIONS

Other liabilities and provisions are summarized as follows:

#### *a) Other current liabilities*

	<u>At December 31,</u>	
	<u>2005</u>	<u>2004</u>
	<u>(In thousands of US\$)</u>	
Engine overhaul provision	60,677	75,506
Withholdings on employee salaries	8,022	6,863
Employee vacations	12,105	9,050
Lan Pass awards and Lan Corporate liability (frequent flyer mileage)	7,096	6,628
Accumulated losses in Florida West International Airways, Inc. (See Note 9)	128	207
Income taxes payable	481	580
Boarding fees	24,866	22,838
Others	13,464	22,008
Total	<u>126,839</u>	<u>143,680</u>



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### b) Provisions (long-term)

	At December 31,	
	2005	2004
	(In thousands of US\$)	
Engine overhaul provision	101,826	84,109
Employee vacations	6,979	7,442
Others	8,472	9,259
Total	117,277	100,810

### NOTE 13 - INCOME TAX

- a) Charges arising from income tax amount to ThUS\$ 1,261, ThUS\$ 970 and ThUS\$ 481 in 2005, 2004 and 2003 respectively, and have been determined based on current local tax legislation.

### b) Deferred income taxes

At December 31, 2005, the accumulated balances from deferred taxes originating from temporary differences were as follows:

	Deferred tax Assets		Deferred tax Liabilities	
	Short-term	Long-term	Short-term	Long-term
	(In thousands of US\$)			
Allowance for doubtful accounts	4,073	—	—	—
Provision for obsolescence of spare parts	4,593	—	—	—
Provision for vacations	1,636	1,096	—	—
Tax loss carry forwards	8	33,274	—	—
Others	4,513	844	—	—
Gross deferred tax assets	14,823	35,214	—	—
Prepaid expenses	—	—	4,555	1,545
Unearned income	—	—	—	16,295
Property and equipment	—	—	—	97,194
Others	—	—	—	15,856
Gross deferred tax liabilities	—	—	4,555	130,890
Less: Complementary accounts	—	(393)	—	(8,883)
Deferred tax assets valuation allowance	(2,598)	(8,390)	—	—
Total	12,225	26,431	4,555	122,007

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At December 31, 2004, the accumulated balances from deferred taxes originating from temporary differences were as follows:

	Deferred tax Assets		Deferred tax Liabilities	
	Short-term	Long-term	Short-term	Long-term
	(In thousands of US\$)			
Allowance for doubtful accounts	3,735	—	—	—
Provision for obsolescence of spare parts	3,814	—	—	—
Provision for vacations	1,382	1,135	—	—
Tax loss carry forwards	1,424	45,328	—	—
Others	4,941	894	—	—
Gross deferred tax assets	15,296	47,357	—	—
Prepaid expenses	—	—	5,209	2,196
Unearned income	—	—	—	11,480
Property and equipment	—	—	—	90,614
Others	—	—	2	12,116
Gross deferred tax liabilities	—	—	5,211	116,406
Less: Complementary accounts	—	(656)	—	(9,205)
Deferred tax assets valuation allowance	—	(10,803)	—	—
Total	15,296	35,898	5,211	107,201

### c) Effect on results

	For the years ended December 31,		
	2005	2004	2003
	(In thousands of US\$)		
Current income tax expense	(1,261)	(970)	(481)
Deferred income tax expense	(26,688)	(27,323)	(17,861)
Other tax expense	(309)	—	—
Total	(28,258)	(28,293)	(18,342)

## NOTE 14 - BALANCES AND TRANSACTIONS WITH RELATED COMPANIES

### a) Accounts receivable and payable with related parties are summarized as follows:

#### Current assets

Notes and accounts receivable from related companies:

Company	Relationship	At December 31,	
		2005	2004
		(In thousands of US\$)	
San Alberto S.A. and subsidiaries	Common ownership	29	189
Ultramar Agencia Marítima Ltda.	Common ownership	—	10
Florida West International Airways Inc.	Equity method investee	237	2,764
Choice Air Courier del Perú S.A.	Equity method investee	38	15
Concesionaria Chucumata S.A.	Equity method investee	185	—
Austral Sociedad Concesionaria S.A.	Equity method investee	287	—
Other	Common ownership	123	—
Total		899	2,978

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### Current liabilities

Notes and accounts payable to related companies:

Company	Relationship	At December 31,	
		2005	2004
(In thousands of US\$)			
Lufthansa Lan Chile Technical Training S.A.	Equity method investee	305	88
Concesionaria Chucumata S.A.	Equity method investee	—	6
Austral Sociedad Concesionaria S.A.	Equity method investee	—	36
Other	Common ownership	22	151
Total		327	281

### Long-term assets

Notes and accounts receivable from related companies:

Company	Relationship	At December 31,	
		2005	2004
(In thousands of US\$)			
Choice Air Courier del Perú S.A.	Equity method investee	178	94
Florida West International Airway Inc.	Equity method investee	10,074	975
Total		10,252	1,069

### Long-term liabilities

Notes and accounts payable to related companies:

Company	Relationship	At December 31,	
		2005	2004
(In thousands of US\$)			
Ultramar Agencia Marítima Ltda.	Common ownership	—	446
Total		—	446

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b) The main transactions with related entities are summarized as follows:

Company	Relationship	Description of transaction	Amount		
			2005	2004	2003
(In thousands of US\$)					
Florida West International	Equity method investee	Aircraft rents received	39,540	35,767	31,095
Airways Inc.	Lan owns 25%	Line aircraft maintenance received	2,402	187	1,582
		Aircraft rents provided	21,898	20,498	18,657
		Air cargo services provided	—	—	952
		Others transactions provided	11,712	6,765	1,488
		Jet fuel payments	10,100	3,817	9,733
		Interline collection	2,568	2,808	3,702
		Other payments	690	3,579	—
Lufthansa Lan Technical	Equity method investee	Training received	905	372	—
Training S.A.	Lan owns 50%	Prepaid training hours	360	375	—
		Other payments	19	19	—
Inmobiliaria Parque					
San Luis Dos S.A.	Common ownership	Real estate transaction	—	15	7,270

The Company's objective is to transact business with its related companies or individuals at prices and at terms equivalent to those used in transacting business with unrelated parties.

### NOTE 15 - LOANS FROM FINANCIAL INSTITUTIONS (LONG-TERM)

Long-term loans from financial institutions are summarized as follows:

	Payable during the years	Interest rate at December 31, 2005	At December 31,	
			2005	2004
			(In thousands of US\$)	
Loan in US dollars	2000 - 2005 (biannually)	LIBOR+1.4	—	1,500
Loan in US dollars	2001 - 2012 (quarterly)	LIBOR+0.3679	60,184	64,505
Loan in US dollars	2001 - 2013 (quarterly)	LIBOR+1.0823	137,641	148,367
Loan in US dollars	2002 - 2006 (quarterly)	LIBOR+1.4	8,248	8,786
Loan in US dollars	2002 - 2012 (quarterly)	LIBOR+1.25	26,180	—
Loan in US dollars	2002 - 2014 (quarterly)	LIBOR+0.9680	122,729	128,173
Loan in US dollars	2005 - 2017 (quarterly)	LIBOR+1.1168	220,096	—
Total			575,078	351,331
Less - current portion			53,104	34,098
Long - term portion			521,974	317,233

All of our loans from financial institutions are collateralized and thus they are secured by the same asset that is subject of the financing. These include five Boeing aircraft, six Airbus aircraft, spare engines and our corporate building. There are no additional collateral arrangements in connection with these financings.

Information with respect to restrictive covenants is detailed under the heading "Covenants" in Note 22 to the financial statements.

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Scheduled payments of long-term loans from financial institutions at December 31, 2005 are as follows:

Payments during the years ended December 31,	(In thousands of US\$)
2007	58,871
2008	52,978
2009	54,498
2010	57,163
2011 - 2015	222,862
2016	75,602
Total	521,974

### NOTE 16 - SECURITIZATION OBLIGATION

Effective March 30, 1999, the Company signed a contract with Pelican Finance Ltd. for the securitization of future credit card receivables aggregating ThUS\$ 60,000 originating from certain ticket agents in the United States. At December 31, 1999, the Company had received the entire proceeds of ThUS\$ 60,000 which were reported as a securitization obligation on the balance sheet. The terms of this contract are for the years between 2001 and 2006 with an annual financial cost of 6.82 %.

On August 22, 2002, the Company signed a new securitization contract with Pelican Finance Ltd. The contract securitizes future credit card receivables aggregating ThUS\$ 40,000. The terms of this contract are for the years between 2006 and 2009 with an annual financial cost of 6.69%. At December 31, 2002, the Company had received the entire proceeds of ThUS\$ 40,000 which were reported as a securitization obligation on the balance sheet.

The principal is payable as follows:

Payments during the years ended December 31,	(In thousands of US\$)
2007	11,971
2008	12,826
2009	6,752
Subtotal	31,549
Current portion - 2006	11,817
Total	43,366

# **NOTE 17 - LEASING OBLIGATIONS**

As indicated in Note 8, at December 31, 2005, the Company financed forty-five jet aircraft pursuant to operating leases and five jet aircraft pursuant to a capital lease. The Company also leases maintenance facilities, other airport facilities, computer equipment and vehicles pursuant to capital leases.

The future minimum lease payments required under capital leases, together with the present value of such minimum lease payments and future minimum lease payments required under operating leases that have initial or remaining non-cancelable lease terms in excess of one year as of December 31, 2005, were as follows:

<u>Payable during the year ending December 31,</u>	<u>Operating leases (aircraft) (In thousands of US\$)</u>	<u>Capital leases</u>
2006	150,562	40,117
2007	139,143	41,819
2008	120,129	43,009
2009	100,955	43,800
2010	91,301	33,483
2011 - 2015	247,579	9,113
2016 - 2020	6,370	10,559
Total minimum lease payments	<u>856,039</u>	<u>221,900</u>
Less: Amount representing interest		(26,879)
Present value of minimum lease payments		195,021
Less: Current portion of obligation		(33,870)
Long-term portion of leasing obligations		<u>161,151</u>

Aircraft operational lease expenses recorded in the Consolidated Statement of Income amounted to ThUS\$ 148,202, ThUS\$ 132,425 and ThUS\$ 139,138 for the years ended December 31, 2005, 2004 and 2003, respectively.

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### NOTE 18 - SHAREHOLDERS' EQUITY

#### *a) Changes in Shareholders' equity*

The changes in shareholders' equity during 2003, 2004 and 2005 were as follows:

	Number of shares	Common stock	Reserves	(Deficit) in development period of subsidiary (In thousands of US\$ except Number of shares)	Retained earnings			Total
					Accumulated earnings	Interim dividends	Net income for the year	
Balances at December 31, 2002	318,909,090	134,303	2,620	(7,138)	157,227	(8,958)	30,808	308,862
Transfer of net income from prior year	—	—	—	7,138	14,712	8,958	(30,808)	—
Final dividends paid	—	—	—	—	(4,854)	—	—	(4,854)
Interim dividends	—	—	—	—	—	(34,999)	—	(34,999)
Net income for the year 2003	—	—	—	—	—	—	83,555	83,555
Balances at December 31, 2003	<u>318,909,090</u>	<u>134,303</u>	<u>2,620</u>	<u>—</u>	<u>167,085</u>	<u>(34,999)</u>	<u>83,555</u>	<u>352,564</u>
Transfer of net income from prior year	—	—	—	—	83,555	—	(83,555)	—
Final dividends paid	—	—	—	—	(41,775)	34,999	—	(6,776)
Interim dividends	—	—	—	—	—	(74,783)	—	(74,783)
Net income for the year 2004	—	—	—	—	—	—	163,552	163,552
Balances at December 31, 2004	<u>318,909,090</u>	<u>134,303</u>	<u>2,620</u>	<u>—</u>	<u>208,865</u>	<u>(74,783)</u>	<u>163,552</u>	<u>434,557</u>
Transfer of net income from prior year	—	—	—	—	163,552	—	(163,552)	—
Final dividends paid	—	—	—	—	(81,777)	74,783	—	(6,994)
Interim dividends	—	—	—	—	—	(71,451)	—	(71,451)
Net income for the year 2005	—	—	—	—	—	—	146,601	146,601
Balances at December 31, 2005	<u>318,909,090</u>	<u>134,303</u>	<u>2,620</u>	<u>—</u>	<u>290,640</u>	<u>(71,451)</u>	<u>146,601</u>	<u>502,713</u>

#### *b) Capital*

The authorized and paid-in capital of the Company is ThUS\$ 134,303 at both December 31, 2004 and 2005 and corresponds to 318,909,090 shares without par value.

#### *c) Other reserves*

Reserves at December 31 of each year were as follows:

	At December 31,	
	2005	2004
	(In thousands of US\$)	
Reserve for adjustment of the value of fixed assets	2,556	2,556
Reserve for adjustment of the value of leased fixed assets	64	64
Total	<u>2,620</u>	<u>2,620</u>

These reserves are not distributable and may only be used for capitalization of the Company.

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### *d) Dividends*

At the Annual General Meeting held on April 25, 2003, the shareholders agreed to distribute a final dividend of ThUS\$ 13,812 (US\$ 0.043309 per share) with respect to net income for 2002, considering an interim dividend of ThUS\$ 8,958 (US\$ 0.028099 per share). These dividends of ThUS\$ 4,854 (US\$ 0.01521 per share) were paid during May, 2003.

At an extraordinary meeting of the Board of Directors held on August 1, 2003, the directors agreed to distribute an interim dividend of ThUS\$ 11,583 (US\$ 0.03632 per share) with respect to net income for 2003.

At a meeting of the Board of Directors held on October 28, 2003, the directors agreed to distribute an interim dividend of ThUS\$ 23,416 (US\$ 0.073425 per share) with respect to net income for 2003.

At the Annual General Meeting held on April 30, 2004, the shareholders agreed to distribute a final dividend amounting to US\$ 0.130995 per share meaning that, after deducting the interim dividends distributed during August and October amounting to US\$ 0.03632 and US\$ 0.073425 per share respectively, a balance of US\$ 0.02125 per share for a total of ThUS\$ 6,776 was to be paid during May 2004.

On August 4, 2004, during an Extraordinary Board of Directors meeting, an interim dividend of US\$ 0.12475 per share for a total of ThUS\$ 39,785 was agreed upon.

On November 30, 2004, the Board of Directors agreed to pay, an interim dividend of US\$ 0.10974 per share for a total of ThUS\$ 34,998 .

At the Annual General Meeting held on April 29, 2005, the shareholders agreed to distribute a final dividend amounting to US\$ 0.25642373 per share after deducting the interim dividends distributed during August and December amounting to US\$ 0.12475 and US\$ 0.10974 per share respectively. A remaining balance of US\$ 0.02192745 per share was paid during May 2005.

At a meeting of the Board of Directors held on August 2, 2005, the directors agreed to distribute an interim dividend of US\$ 0.11430 per share with respect to net income for 2005.

At a meeting of the Board of Directors held on January 31, 2006, the directors agreed to distribute an interim dividend of US\$ 0.10975 per share with respect to net income for 2005. These dividends will be paid during March, 2006 and they are classified in Dividends Payable at December 31, 2005.

### *e) Major shareholders*

The major shareholders of the Company at December 31, 2005, were as follows:

	<b>Percentage of Ownership</b>
	<b>%</b>
Inversiones Costa Verde Ltda. y Compañía en Comandita por Acciones	27.01
Axxion S.A.	20.64
The Bank of New York. (on behalf of ADR holders)	16.62
Total	64.27

In July 2004, Inversiones Costa Verde Ltda. y Compañía en Comandita por Acciones, Axxion S.A. and Inversiones Santa Cecilia S.A. (shareholder with 6.4% ownership) entered into a management and control agreement. At December 31, 2005 this agreement is still in effect.



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**NOTE 19 – OTHER OPERATING REVENUES**

The Other revenues were comprised of the following:

	<b>For the year ended December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
	<b>(In thousands of US\$)</b>		
Aircraft leases	23,806	40,123	38,825
Logistics and couriers	39,932	19,906	27,400
Ground services	18,842	13,468	10,800
Duty free	15,602	12,288	10,799
Storage and customs brokerage	10,689	8,947	10,100
Others	26,445	29,508	20,468
<b>Total</b>	<b>135,316</b>	<b>124,240</b>	<b>118,392</b>

**NOTE 20 - OPERATING EXPENSES**

Wages and benefits are summarized as follows:

	<b>At December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
	<b>(In thousands of US\$)</b>		
Flight personnel	110,298	85,739	66,418
Maintenance personnel	41,549	29,635	26,702
Ground personnel	73,800	63,029	53,873
Administrative and corporate employees	145,949	114,420	93,931
<b>Total</b>	<b>371,596</b>	<b>292,823</b>	<b>240,924</b>

Other operating expenses include general and administrative expenses such as rents, insurance and other expenses of ThUS\$ 121,618 in 2005, ThUS\$ 97,036 in 2004 and ThUS\$ 81,173 in 2003.

Other operating expenses also include advertising, promotional, and marketing expenses of ThUS\$ 19,490 in 2005, ThUS\$ 15,607 in 2004 and ThUS\$ 11,550 in 2003.

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**NOTE 21 - OTHER INCOME (EXPENSE) - NET**

Other income (expense) - net for each year are summarized as follows:

	<b>For the year ended December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
	<b>(In thousands of US\$)</b>		
Non-operating income:			
Swap fuel contracts	51,480	46,529	12,302
Foreign currency transactions (net)	6,004	2,353	12,055
Earnings on investments (equity method)	583	327	275
Income from financial advisory services and others	—	—	485
Other	5,296	2,443	6,582
<b>Total</b>	<b>63,363</b>	<b>51,652</b>	<b>31,699</b>
Non-operating expenses:			
Amortization of goodwill	(3,216)	(3,134)	(3,272)
Losses on investments (equity method)	—	(576)	(951)
Non-recurring indemnities paid to employees	—	—	(1,121)
Other	(1,913)	(2,780)	(2,232)
<b>Total</b>	<b>(5,129)</b>	<b>(6,490)</b>	<b>(7,576)</b>
Other income (expense) - net	<b>58,234</b>	<b>45,162</b>	<b>24,123</b>

During 2001, the Company made the decision to reduce its operations by approximately 10%, with the most substantial reduction being in flights to the United States due to the aftermath of the September 11 terrorist attacks. In connection with the reduction in service, the Company reduced its workforce by approximately 7%, resulting in non-operating expenses of ThUS\$ 5,540 due to the payment of indemnities to terminated employees during 2001. These costs represent the termination of 761 maintenance, cabin crew and administrative employees during the year. Additional payments, due to employee claims resulting from these actions were paid during 2003.

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### NOTE 22 - COMMITMENTS AND CONTINGENCIES

At December 31, 2005 and 2004, the Company had granted the following mortgages, liens and guarantees:

*Direct Guarantees (In thousands of US\$):*

Type of Guarantee	Assets Pledged as Collateral		Amount outstanding at Balance sheet date	
	Type	Book Value	2005	2004
Mortgage, and pledge guarantee	Aircraft and motors	599,793	566,830	341,045
Mortgage	Building	9,269	8,248	8,786
Pledge	Motors	6,559	—	1,500
Pledge	Spare parts	331	—	—

*Indirect Guarantees:*

The Company guaranteed a ThUS\$ 3,500 letter of credit dated April 26, 2001, granted in favor of Celestial Aviation Trading 16 Limited due to an Aircraft Lease Agreement (“Lease”) between Lan Cargo S.A. (formerly Lan Chile Cargo S.A.) and Celestial Aviation Trading 16 Limited. The Company guarantee is valid until the lease expiration date (November 1, 2006) and was required by Celestial Aviation Trading 16 Limited, the owner of the aircraft. As a result, the Company would be liable for repayment of such letter of credit, should Lan Cargo S.A. not fulfill its obligation under the lease. No liability is carried on the balance sheet for the Company’s obligation under the guarantee.

*Commitments*

On March 20, 1998, the Company entered into a purchase agreement for twenty Airbus A320 aircraft (with the option to purchase an additional twenty aircraft). The estimated cost of these twenty aircraft is ThUS\$ 840,000. This agreement was subsequently amended to require the delivery of A319 aircraft instead of A320 aircraft. In August 1999, the Company entered into another agreement to purchase seven Airbus A340 aircraft (with an option to purchase an additional fourteen aircraft in the future). The estimated maximum cost for these seven aircraft is ThUS\$ 700,000.

During November 2003, the Company agreed with Airbus Industries and a bank syndicate led by Credit Lyonnais to cancel the delivery of one Airbus A340 aircraft which was scheduled for 2004. At the same time, it exercised call options for three Airbus A319 aircraft. Additionally, all future deliveries of Airbus A320’s were changed for Airbus A319’s.

On November 11, 2004, the Company entered into a purchase agreement with The Boeing Company to acquire four additional aircraft of the 767-300 family with delivery during 2006. This purchase agreement provides for flexibility to choose between passenger or freighter aircraft. The purchase commitment amounts to US\$ 560 million at December 31, 2005.

On April 28, 2005, the Company entered into a purchase agreement for three Boeing 767-300 aircraft for a total of ThUS\$ 450,000. This purchase agreement provides for flexibility to choose between passenger or freighter aircraft. The delivery is scheduled for 2006 and 2007.

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On July 20, 2005, the Company entered into a purchase agreement for an additional 3 Boeing 767-300 ER aircraft for a total of ThUS\$ 450,000. One of these aircraft is for passengers and the Company has the flexibility to choose between passenger or freighter for the remaining two aircraft. The delivery is scheduled for 2007 and 2008.

On October 4, 2005, the Company agreed with Airbus Industries to a new modification with respect to the agreement signed on March 20, 1998. This amendment is related to the purchase of thirty two new Airbus family aircraft (with an option to purchase an additional fifteen aircraft in the future). Such aircraft are expected to be delivered during 2006, 2007 and 2008. The approximated cost for this purchase is ThUS\$ 960,000.

### *Contingencies*

At December 31, 2005, the Company was a defendant in five labor disputes filed by the Pilots' Union and the Cabin Crew Union, requesting the payment of bonuses for the years ended December 31, 1998, 1999, 2000, 2001 and 2002. The Company has made no provision for these amounts because management believes that the outcome of the suits will be favorable to the Company and any losses incurred will not be material.

At December 31, 2005, the Company was a defendant in a number of commercial lawsuits of the type normally associated with the Company's business and involving claims for damages for insignificant amounts. The Company has made no provision for these amounts because management believes that most of the resulting judgments will be favorable and any losses incurred will not result in any material liability to the Company.

### *Covenants*

As a result of the various contracts entered into by the Company to finance the Boeing 767 aircraft that are financed by the Export—Import Bank of the United States, the Company is required to comply with certain restrictions regarding shareholder composition and disposal of assets.

The loan agreement with BBVA - Banco Bhif has placed restrictions on the Company's ability to dispose of certain of its fixed assets.

As a result of the various contracts entered into by the Company to finance the Airbus A320 aircraft that are guaranteed by various European export credit agencies, the Company is required to comply with certain restrictions regarding shareholder composition and disposal of assets.

As a result of the securitization contracts with Pelican Finance Ltd. in March 1999 and August 2002 respectively, there are certain restrictions on the use of the future cash flows which have been securitized.

As of December 31, 2005, the Company was in compliance with all covenants.

### *Other*

At December 31, 2005, the Company had approved credit lines in the amount of ThUS\$ 140,000. These credit lines are used mainly to cover (a) stand-by credit letters issued in favor of aircraft lessors and airports in the United States of America and other countries and (b) bank credit letters issued in favor of the local air administration or the Chilean Government.

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**NOTE 23 - FOREIGN CURRENCIES**

Foreign currency assets and liabilities at December 31 of each year are summarized as follows:

	<b>At December 31,</b>	
	<b>2005</b>	<b>2004</b>
	<b>(In thousands of US\$)</b>	
<b>Assets denominated in:</b>		
Chilean pesos	79,881	110,625
Other currencies	66,359	44,383
Total	<u>146,240</u>	<u>155,008</u>
<b>Liabilities denominated in:</b>		
Chilean pesos	61,092	51,126
Other currencies	37,469	23,451
Total	<u>98,561</u>	<u>74,577</u>

**NOTE 24 - SEGMENT REPORTING**

The Company reports segment information in accordance with Statement of Financial Accounting Standard No. 131, “Disclosures About Segments of an Enterprise and Related Information” (“SFAS 131”). SFAS 131 establishes standards for reporting information about operating segments in annual financial statements as well as related disclosures about products and services, geographic areas and major customers. Operating segments are defined as components of an enterprise about which separate financial statement information is available that is evaluated regularly by the chief operating decision maker in making decisions about allocating resources and assessing performance. The Company considers that it has one reportable segment. The Company’s operating revenues by geographic region are summarized below:

	<b>Year ended December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
	<b>(In thousands of US\$)</b>		
Domestic (Chile)	428,644	332,890	294,076
North America	1,194,996	1,099,936	831,832
South America (excluding Chile)	619,860	458,594	342,223
Europe	158,544	146,143	134,177
Pacific	104,309	55,382	36,492
Total	<u>2,506,353</u>	<u>2,092,945</u>	<u>1,638,800</u>

The Company attributes operating revenues to the geographical area in which the relevant overseas point of the flight lies. The Company's tangible assets consist primarily of flight equipment which is mobile across geographic markets and, therefore, has not been allocated.

**NOTE 25 – SUBSEQUENT EVENTS**

- a) On January 31, 2006 at a meeting of the Board of Directors, the Directors of the Company agreed to distribute an interim dividend of US\$ 0.10975 per share with respect to net income for 2005 to shareholders of record January 26, 2006. These dividends are reflected in Note 18 as interim dividends at December 31, 2005 and were paid in March 2006.
- b) Effective January 1, 2006, the Company changed its method of accounting for heavy aircraft and engine maintenance costs associated with its owned aircraft. Previously, the Company accrued a liability for these costs in its consolidated balance sheet under the caption "Provisions". Such provision was established based on the total cycles and flight hours flown by an aircraft since its incorporation into the Company's fleet. Under the new method, the costs incurred in heavy aircraft and engine maintenance will be capitalized and amortized to the next overhaul while all other minor maintenance costs will be expensed as they are incurred. Considering the increase in the level of the Company's operations and aircraft fleet, this new method is preferable as it provides a better matching of revenues and expenses, and is consistent with prevalent industry practice adopted by major airlines. Under Chilean GAAP, the cumulative effect of this accounting change at January 1, 2006, was to increase non-operating income by US\$ 40.3 million.

As described above, this change in accounting principle will be applied prospectively. Had this change been applied retrospectively the following Chilean GAAP income statement accounts for fiscal years 2003, 2004 and 2005 would have been affected by the change in this accounting principle:

For the year ended December 31,	Cost of depreciation and amortization determined by (in thousands of US\$)		Cost of aircraft maintenance determined by (in thousands of US\$)	
	Accrual method	Deferral method	Accrual method	Deferral method
2003	72,631	72,111	97,862	96,682
2004	77,443	76,840	120,818	116,621
2005	80,456	78,431	132,198	135,423

- c) The Company has no other knowledge of any other subsequent events that would have a significant effect on the balances or interpretation of these financial statements.

**NOTE 26 - DIFFERENCES BETWEEN CHILEAN AND UNITED STATES GENERALLY ACCEPTED ACCOUNTING PRINCIPLES**

Accounting principles generally accepted in Chile ("Chilean GAAP") vary in certain important respects from accounting principles generally accepted in the United States ("US GAAP"). Such differences involve certain methods for measuring the amounts shown in the financial statements, as well as additional disclosures required by US GAAP.

1. Differences in measurement methods

The principal methods applied in the preparation of the accompanying financial statements, which have resulted in amounts which differ from those that would have otherwise been determined under US GAAP, are as follows:

a) *Deferred income tax*

As discussed in Note 13, effective January 1, 2000, the Company began applying Technical Bulletin No. 60 of the Chilean Institute of Accountants concerning deferred income taxes. Technical Bulletin No. 60 requires the recognition of deferred income taxes for all temporary differences arising after January 1, 2000, whether recurring or not, using an asset and liability approach. For US GAAP purposes, the Company has always applied Statement of Financial Accounting Standard ("SFAS") No. 109, "Accounting for Income Taxes", whereby income taxes are also recognized using substantially the same asset and liability approach. Deferred income tax assets and liabilities established for temporary differences between the financial reporting basis and tax basis of the Company's assets and liabilities are based on enacted rates at the dates that the temporary differences are expected to reverse. The effect of changes in tax rates is included in income for the period that includes the enactment date.

After the year ended December 31, 1999, Chilean GAAP and US GAAP differ due to the recognition for US GAAP purposes of the reversal of deferred income taxes included in the US GAAP reconciliations in years prior to 2000.

Prior to the implementation of Technical Bulletin No. 60, no deferred income taxes were recorded under Chilean GAAP if the related timing differences were expected to be offset in the year that they were projected to reverse by new timing differences of a similar nature.

Furthermore, deferred income tax assets under both Chilean and US GAAP should be reduced by a valuation allowance if, based on the weight of available evidence, it is more likely than not that some portion or all of the deferred income tax assets will not be realized. The valuation allowance should be sufficient to reduce the deferred income tax asset to an amount that is more likely than not to be realized.

The effect of providing for deferred income taxes for the differences between the amounts shown for assets and liabilities in the balance sheet and the tax bases of those assets and liabilities is included in paragraph 1 m) below and certain disclosures required under FAS 109 are set forth under paragraph 2 c) below.

b) *Goodwill*

Until December 31, 2003, under Chilean GAAP, the excess of cost over the net book value of a purchased company was recorded as goodwill (the book value purchase method), which was then amortized to income over a maximum period of twenty years. Amortization of goodwill may be accelerated if the acquired company generates sufficient income to absorb the additional amortization in any given year. The excess of net book value over the cost of an investment was considered to be negative goodwill under Chilean GAAP and is also amortized to income over a maximum period of twenty years. The amortization of negative goodwill may be accelerated if the acquired company sustains losses.

Under US GAAP, goodwill and other intangibles are accounted for under SFAS No. 141, “Business Combinations” and SFAS No. 142, “Goodwill and Other Intangible Assets”. SFAS No. 141 requires the purchase method of accounting be used for all business combinations initiated after June 30, 2001 and prohibits the use of the pooling-of-interests method of accounting after this date. With respect to the purchase method of accounting, the cost of an investment is assigned to the tangible and identified intangible assets acquired and liabilities assumed on the basis of their fair values at the date of acquisition. Any excess of cost over the fair value of net assets acquired is recorded as goodwill. If an excess of acquired net assets over cost arises, the excess is allocated to reduce proportionally the values assigned to noncurrent assets (except long-term investments in marketable securities) in determining their fair values. If the allocation reduces the noncurrent assets to zero value, the remainder of the excess over cost (negative goodwill) is written off immediately as an extraordinary gain. SFAS No. 141 establishes specific criteria for the recognition of intangible assets separately from goodwill and requires unallocated negative goodwill to be written off immediately as an extraordinary gain (instead of being deferred and amortized).

SFAS No. 142, “Goodwill and Other Intangible Assets” establishes the following:

- The accounting for a recognized intangible asset is based on its useful life to the reporting entity. An intangible asset with a finite useful life is amortized over the life of the asset, but goodwill and other intangible assets with indefinite useful lives are not amortized.
- The remaining useful lives of intangible assets being amortized are evaluated each reporting period to determine whether events and circumstances warrant a revision to the remaining period of amortization. If the estimate of an intangible asset’s remaining useful life is changed, the remaining carrying value of the intangible asset is amortized prospectively over the revised remaining useful life.
- Goodwill and other intangible assets with indefinite useful lives that are not subject to amortization are tested for impairment at least annually.
- All goodwill must be assigned to a reporting unit, which is defined as an operating segment or one level below an operating segment.

SFAS No. 142 became effective for years beginning after December 15, 2001. Accordingly, goodwill amortization was ceased for US GAAP purposes beginning in 2002.

As discussed in Note 9, the Company made a number of acquisitions in 2002, 2003, and 2005. The acquisitions in 2002 and 2003 were recorded pursuant to the book value purchase method for Chilean GAAP purposes. For these acquisitions there were no significant differences in the allocation of the purchase price or the determination of goodwill between the book value purchase method in accordance with Chilean GAAP and the purchase accounting method required pursuant to SFAS No. 141 in accordance with US GAAP. For acquisitions after December 31, 2003 the fair value purchase method is used for both Chilean GAAP and US GAAP. The companies acquired are not material to the consolidated financial position of the Company and therefore, pro forma financial statements showing the effect on operations as if the acquisitions had been completed at the beginning of the period are not presented.



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For US GAAP purposes, the reversal of amortization of goodwill from the purchases made by the Company and the purchase accounting adjustments of conforming business acquisitions prior to June 30, 2001 to US GAAP are shown in paragraph 1 m) below. As a result of the annual impairment tests performed by the Company, no adjustment to the book value of goodwill was deemed necessary.

Under Chilean GAAP, the cost of an equity method investment is separated into an investment component (based on the purchase of the proportionate share of equity according to book values) and a goodwill component (based on the difference between the amount paid and the proportional book value of the investment). Under US GAAP, these components are combined in one balance sheet caption as an investment, and goodwill is determined in a manner similar to a consolidated subsidiary based on proportionate ownership. No disclosure has been presented for the effect of the reclassification between goodwill as determined under Chilean GAAP for equity method investments and goodwill determined under US GAAP as the effect of this reclassification is not significant.

The effects of reclassifying negative goodwill for the acquisitions in 2002 and 2003 as determined under Chilean GAAP to proportionately reduce the values assigned to the non-current assets acquired in accordance with US GAAP are not significant.

### *c) Revaluation of property and equipment*

As mentioned in Note 2 k), certain property and equipment are valued in the financial statements at amounts determined in accordance with a technical appraisal. The revaluation of property and equipment is an accounting principle that is not generally accepted in the United States. The effects of the reversal of this revaluation, as well as of the related accumulated depreciation and depreciation expense for each year, are shown below under paragraph 1 m).

### *d) Minimum dividend*

As required by the Chilean Companies Act, unless otherwise decided by the unanimous vote of the issued and subscribed shares, an open stock corporation must distribute a cash dividend in an amount equal to at least 30% of the company's net income for each year adjusted for the deficit under developing period as determined in accordance with Chilean GAAP. Under Chilean GAAP, even though the minimum dividend is a legal requirement, the dividend is not recorded until it is declared by the Company. For 2005 and 2004, the full amount of the required dividend was declared as interim dividends and recorded by the Company, therefore, no adjustment is necessary.

### *e) Equity method of accounting*

As mentioned in Note 2 l), for Chilean GAAP purposes, beginning in 2005, investments in related companies are accounted for pursuant to the equity method when the company's investment represents between 20% and 50% of the voting stock of the investee. Prior to 2005, when investments in related companies represented between 10% and 50% of voting rights the equity method was used. For US GAAP purposes prior to February 1, 2003, investments in related companies required the use of the equity method of accounting for investments which give the investor the ability to exercise significant influence over operating and financial policies of the investee. For those companies which were determined to be controlled through the Company's investment (generally, ownership of over 50% of the outstanding voting shares), US GAAP required consolidation. Subsequent to February 1, 2003, US GAAP requires the determination of whether an entity should be consolidated in accordance with FASB Interpretation No. 46, "Consolidation of Variable Interest Entities" ("FIN 46"), focused on identifying entities for which a controlling financial interest is achieved through means other than voting rights. Under this interpretation, a variable interest entity must be consolidated if certain consolidation

requirements are met. An enterprise should consolidate an entity if that enterprise has a variable interest in the entity that will absorb a majority of the entity's expected losses, receive a majority of the entity's expected residual returns, or both. FIN 46, as revised by FIN 46R, was effective on February 1, 2003 for new transactions and effective for reporting periods after March 15, 2004 for transactions entered into prior to February 1, 2003.

Relative to the Company's investments in related companies, there are no differences in the application of the equity method or consolidation between Chilean GAAP and US GAAP.

*f) Monetary correction of subsidiaries*

As indicated in Note 2 d), the Chilean peso financial statements of certain of the Company's Chilean subsidiaries are restated through the application of price-level restatements in accordance with Chilean GAAP to show the effects of changes in the purchasing power of the Chilean peso, using indicators published by the National Institute of Statistics. The financial statements of such Chilean subsidiaries are then remeasured to US dollars at the exchange rates prevailing on December 31 of each year.

The inclusion of price-level restatements when the US dollar is the reporting currency is not permitted under US GAAP. However, in the case of the Company, the effects of including price-level restatement at the subsidiary level are not significant and accordingly the effects of reversing the price-level restatement are not included in the reconciliation of net income and net equity accounts to US GAAP in paragraph 1 n) below.

*g) Investment securities*

Under Chilean GAAP, investments in bonds held by the Company are carried at the lower of cost plus accrued interest or market value. Under Chilean GAAP, mutual funds are stated at market value based on year-end quoted values and unrealized gains and losses are recorded in the current year Consolidated Statement of Income. Under SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities", investment securities, which include debt and certain equity securities, are accounted for as follows:

- Debt securities that the Company has the positive intent and ability to hold to maturity are classified as held-to-maturity securities and are reported at amortized cost.
- Debt and equity securities that are bought and held principally for the purpose of selling them in the near term are classified as trading securities and are reported at fair value, with unrealized gains and losses included in earnings.
- Debt and equity securities not classified as either held-to-maturity or trading securities are classified as available-for-sale securities and reported at fair value, with unrealized gains and losses excluded from earnings and reported in a separate component of shareholders' equity.

The Company's investments in bonds are classified as available for sale securities for the purposes of SFAS No. 115. The effect of the difference between Chilean GAAP and US GAAP in accounting for the Company's investment in bonds is included in the reconciliation of reported Net income to Comprehensive income in accordance with US GAAP in paragraph 1 m) below. There is no difference between Chilean GAAP and US GAAP for the Company's investments in mutual funds as they are classified as trading securities for the purpose of SFAS No. 115.

*h) Presentation in Statement of cash flows*

Under Chilean GAAP, payments of leasing obligations subsequent to the date of purchase are treated in the Consolidated Statement of Cash Flows as additions of property and equipment and classified as cash

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outflows from investing activities. Under US GAAP, incurring directly-related debt to the seller of property and equipment is a financing transaction and subsequent payments of principal on that debt are thus considered to be cash outflows from financing activities.

As a result of these differences, the Consolidated Statement of Cash Flows under Chilean GAAP would have to be adjusted as follows to present the statement in accordance with US GAAP:

	Increase (decrease) in cash flow		
	2005	2004	2003
	(In thousands of US\$)		
Net cash (used in) provided by financing activities under Chilean GAAP	177,888	(134,768)	(117,050)
Loans repaid	(38,180)	(11,504)	(3,899)
Net cash (used in) provided by financing activities under US GAAP	<u>139,708</u>	<u>(146,272)</u>	<u>(120,949)</u>
Net cash (used in) investing activities under Chilean GAAP	(560,422)	(152,869)	(120,353)
Acquisitions of property and equipment	38,180	11,504	3,899
Net cash (used in) investing activities under US GAAP	<u>(522,242)</u>	<u>(141,365)</u>	<u>(116,454)</u>

Net cash and cash equivalents at the end of year under US GAAP is as follows:

	At December 31,		
	2005	2004	2003
	(In thousands of US\$)		
Cash	11,733	11,620	4,988
Time deposits	34,519	179,715	128,950
Defined-term mutual funds (included in Marketable Securities)	<u>65,019</u>	<u>25,533</u>	<u>23,814</u>
Total	<u>111,271</u>	<u>216,868</u>	<u>157,752</u>

There are no significant non-cash investing or financing transactions in the three years ended December 31, 2005.

### i) *Classification of income and expenses*

Under Chilean GAAP, the following income and expenses arising during the years 2005, 2004 and 2003 are classified as Other income (expense) - net whereas under US GAAP they would be recorded within continuing operations:

	Year ended December 31,		
	2005	2004	2003
	(In thousands of US\$)		
Non-operating income:			
Swap fuel contracts	51,480	46,529	12,302
Total	<u>51,480</u>	<u>46,529</u>	<u>12,302</u>
Non-operating expenses:			
Non-recurring indemnities paid to employees	—	—	1,121
Total	<u>—</u>	<u>—</u>	<u>1,121</u>

j) *Internal use software*

As mentioned in Note 2 k), under Chilean GAAP all disbursements for the development of internal use software are charged to the results of operations as incurred. Under US GAAP, certain costs related to internal use software are capitalized while others are charged to the results of operations. External direct costs of materials and services consumed in developing or obtaining internal use computer software, payroll and payroll-related costs for employees who are directly associated with and who devote time to the internal use computer software project and interest costs incurred while developing internal use computer software are capitalized. Maintenance, training, data conversion and reengineering costs are charged to the results of operations as incurred. However, in the case of the Company, the costs relating to internal use software are not significant and accordingly, these costs are not included in the reconciliation to US GAAP of net income and net equity accounts in paragraph 1 m) below.

k) *Recognition of tax loss carryforwards*

At December 31, 2000, Lan Perú had tax loss carryforwards of ThUS\$ 7,590 resulting in a deferred tax asset of ThUS\$ 2,326. A valuation allowance of ThUS\$ 2,326 was provided to offset the entire deferred tax asset because at that time it appeared unlikely that these tax losses would be utilized in future years. Lan Perú was an equity method investee at December 31, 2000 and during 2001 the Company acquired an additional 21% ownership interest and Lan Perú became a consolidated subsidiary. No deferred tax asset was recognized under Chilean GAAP on the date of purchase. During 2001, Lan Perú had taxable income and utilized ThUS\$ 1,673 of the deferred tax asset, leaving a balance of ThUS\$ 653 which expired without being utilized. In accordance with US GAAP, when tax loss carryforwards that were not recognized at the acquisition date are recognized in a subsequent period, they first reduce to zero any positive goodwill related to the acquisition; then they reduce to zero all other noncurrent intangible assets; and finally, they reduce income tax expense. For Chilean GAAP purposes, the tax loss was used to reduce income tax expense without first reducing existing goodwill. As a result, the US GAAP reconciliation in paragraph 1 m) below includes an adjustment to decrease goodwill on the purchase of Lan Perú in 2001 by ThUS\$ 488 and increase the current income provision by the same amount. The adjustment is based on the acquired ownership interest of 21% applied to the deferred tax asset of ThUS\$ 2,326 recognized in 2001.

l) *Derivative financial instruments*

The Company uses interest rate swap and cap agreements to reduce its exposure from variable interest bearing liabilities and commitments, and has entered into a treasury rate lock contract in order to hedge exposure of changes in the treasury rate. It also enters into commodity (jet fuel and West Texas intermediate) swap and call contracts to fix the price for a given quantity of the aforementioned

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commodity, and “costless collars” which are a combination of call and put options so as to ensure a price range for jet fuel. In order to reduce the impact of foreign exchange rate fluctuations, the Company enters into foreign exchange hedge contracts.

Under Chilean GAAP, derivatives are accounted for in accordance with Technical Bulletin 57, “Accounting for Derivative Contracts” (TB 57). Under TB 57, all derivative financial instruments should be recognized on the balance sheet at their fair value. In addition, TB 57 requires that derivative financial instruments be classified as non-hedging (investment) instruments and hedging instruments, the latter further divided into those covering recognized assets or liabilities or an unrecognized firm commitment and those covering forecasted transactions.

Contracts to cover recognized assets or liabilities or an unrecognized firm commitment act as hedging instruments against the risk of a change in the fair value of a hedged item. The differences resulting from the changes in the fair value of both the hedged item and the derivative instrument should be accounted for as follows:

- a) If the net effect is a loss, it should be recognized in earnings in the period of change.
- b) If the net effect is a gain, it should be recognized when the contract is closed and accordingly deferred on the balance sheet.
- c) If the net effect is a gain and net losses were recorded on the transaction in prior years, a gain should be recognized in earnings in the current period up to the amount of net losses recorded previously.
- d) If the effect is a net loss and net gains were recorded (as a deferred revenue) on the transaction in prior years, the gain should be utilized to offset the net loss before recording the remaining loss in the results of operations for the year.

Contracts to cover forecasted transactions are those that have the objective of protecting cash flow risks of a transaction expected to occur in the future (a cash flow hedge). The hedging instrument should be recorded at its fair value and the changes in fair value should be stated on the balance sheet as unrealized gains or losses. When the contract is closed, the unrealized gains or losses on the derivative instrument should be recognized in earnings without affecting the cost or sales price of the asset acquired or sold in the transaction. However, probable losses arising from purchase commitments should not be deferred.

Non-hedging (investment) instruments should also be presented at their fair value, with changes in fair value reflected in the earnings of the period in which the change in fair value occurs.

For US GAAP reconciliation purposes only, the Company has adopted SFAS No. 133 “Accounting for Derivative Instruments and Hedging Activities,” as amended by SFAS 137 and SFAS 138 on the same matter (collectively referred to herein as “SFAS 133”). SFAS 133 establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the Consolidated Balance Sheet and measure those instruments at fair value. If certain conditions are met, a derivative may be specifically designated as (a) a hedge of the exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment, (b) a hedge of the exposure to variable cash flows of a forecasted transaction or to the variability of the cash flows that are to be received or paid in connection with a recognized asset or liability or (c) a hedge of the foreign currency exposure of a net investment in a foreign operation, an unrecognized firm commitment, an available-for-sale security, a foreign-currency-denominated forecasted transaction or a recognized asset or liability.

As indicated below in paragraph 2 f), the accounting for changes in the fair value of a derivative depends on the intended use of the derivative and the resulting designation.

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The effect of the differences in accounting for derivative financial instruments under Chilean and US GAAP is included in paragraph 1 m) below. Additional information concerning derivative financial instruments that is required to be disclosed under SFAS 133 is set forth below in paragraph 2 f).

### *m) Effects of conforming to US GAAP*

The adjustments to reported net income required to conform with US GAAP are as follows:

	For the year ended December 31,		
	2005	2004	2003
	(In thousands of US\$)		
Net income in accordance with Chilean GAAP financial statements	146,601	163,552	83,555
Deferred income tax provision (par. 1 a)	2,923	(5,786)	(18)
Purchase accounting adjustments of property and equipment on Lan Cargo S.A (Ex Lan Chile Cargo S.A.) acquisition (par. 1 b)	(64)	(64)	(64)
Reversal of depreciation of the revaluation from technical appraisal of property and equipment (par. 1 c)	—	—	30
Fair value of derivative not considered to be a hedge (par. 1 l and par. 2 f)	—	414	1,531
Ineffectiveness of cash flow hedges of forecasted jet fuel purchases (par. 1 l and par. 2 f)	2,233	(606)	453
Ineffectiveness of cash flow hedges of forecasted securitization (net of amortization) (par. 1 l and par. 2 f)	59	59	59
Reversal of goodwill and its amortization (par. 1 b)	3,218	3,134	3,267
Net income in accordance with US GAAP	<u>154,970</u>	<u>160,703</u>	<u>88,813</u>
	For the year ended December 31,		
	2005	2004	2003
	(In thousands of US\$)		
Comprehensive income (loss):			
Fair value of cash flow hedges:			
Interest rate contracts (par. 1 l and par. 2 f)	9,441	4,179	8,298
Jet fuel swaps (par. 1 l and par. 2 f)	(6,344)	446	9,719
Treasury rate lock (par. 1 l and par. 2 f)	471	471	471
Unrealized gain (loss) on investment	(2,233)	10,565	77
Other comprehensive income (loss) before taxes	1,335	15,661	18,565
Income tax (expense) benefit related to items of other comprehensive income (par. 1 a)	(227)	(2,663)	(3,156)
Comprehensive income in accordance with US GAAP	<u>156,078</u>	<u>173,701</u>	<u>104,222</u>

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The adjustments required to conform Total Shareholders' equity to US GAAP are as follows:

	<b>For the year ended December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
	<b>(In thousands of US\$)</b>		
Total Shareholders' Equity in accordance with Chilean GAAP financial statements	502,713	434,557	352,564
Deferred income tax provision (par. 1 a)	(15,949)	(18,872)	(13,086)
Purchase accounting adjustments of property and equipment arising from Lan Cargo S.A. (Ex Lan Chile Cargo S.A.) acquisition (par. 1 b)	492	556	620
Reversal of utilization of tax loss carryovers in Perú (par. 1 k)	(488)	(488)	(488)
Fair value of derivative not considered to be a hedge (par. 1 l and par. 2 f)	—	—	(414)
Ineffectiveness of cash flow hedges of forecasted jet fuel purchases (par. 1 l and par. 2 f)	2,080	(153)	453
Ineffectiveness of cash flow hedge of forecasted securitization (net of amortization ) (par. 1 l and par. 2 f)	(206)	(265)	(324)
Difference in purchase accounting adjustments (par. 1 b)	(20,814)	(20,814)	(20,814)
Amortization of goodwill basis differences pre-SFAS 141 (par. 1 b)	8,201	8,201	8,201
Reversal of amortization of goodwill under chilean gaap subsequent to implementation of SFAS 141 (par. 1 b)	12,767	9,549	6,415
<b>Total Shareholders' Equity in accordance with US GAAP</b>	<b>488,796</b>	<b>412,271</b>	<b>333,127</b>

	<b>For the year ended December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
	<b>(In thousands of US\$)</b>		
Accumulated other comprehensive loss	3,363	(9,635)	(25,044)
Other comprehensive income (loss), net of income tax	1,108	12,998	15,409
<b>Accumulated other comprehensive income (loss) in accordance with US GAAP</b>	<b>4,471</b>	<b>3,363</b>	<b>(9,635)</b>
<b>Total shareholder's equity in accordance with US GAAP including accumulated other comprehensive income (loss)</b>	<b>493,267</b>	<b>415,634</b>	<b>323,492</b>

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The changes in Total Shareholders' equity determined under US GAAP are summarized as follows:

	<b>In thousands of US\$</b>
Balance at December 31, 2002	258,873
Reversal of accrued minimum dividend at December 31, 2002	250
Distribution of final 2002 dividend	(4,854)
Distribution of interim 2003 dividend	(34,999)
Other comprehensive (loss):	
Gain from fair value of cash flow hedges	18,488
Unrealized gain on investment	77
Income tax expense related to items of other comprehensive income	(3,156)
Net income for the year	88,813
Balance at December 31, 2003	323,492
Balance at December 31, 2003	323,492
Distribution of final 2003 dividend	(6,776)
Distribution of interim 2004 dividend	(74,783)
Other comprehensive income:	
Gain from fair value of cash flow hedges	5,096
Unrealized gain on investment	10,565
Income tax expense related to items of other comprehensive income	(2,663)
Net income for the year	160,703
Balance at December 31, 2004	415,634
Balance at December 31, 2004	415,634
Distribution of final 2004 dividend	(6,994)
Distribution of interim 2005 dividend	(71,451)
Other comprehensive income:	
Gain from fair value of cash flow hedges	3,568
Unrealized loss on investment	(2,233)
Income tax expense related to items of other comprehensive loss	(227)
Net income for the year	154,970
Balance at December 31, 2005	493,267

## 2. Additional US GAAP disclosure requirements

The information set forth below is required under US GAAP but not under Chilean GAAP.

### a) Earnings per share

The following disclosure of earnings per share information is not generally required for presentation in financial statements under Chilean GAAP but is required under US GAAP:

	<b>Year ended December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
	<b>(In US\$)</b>		
Earnings per share under Chilean GAAP	0.46	0.51	0.26
Basic and diluted earnings per share under US GAAP	0.49	0.50	0.28
Weighted-average number of shares of common stock outstanding for basic and diluted earnings per share (in thousands)	318,909	318,909	318,909

The earnings per share data shown above is determined by dividing net income for both Chilean GAAP and US GAAP purposes by the weighted-average number of shares of common stock outstanding during each year.



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b) *Investment securities*

Shown below are the cost, gross unrealized gain and losses and approximate fair value of marketable securities under US GAAP (see paragraph 1g):

	Cost		Gross Unrealized gains		Gross Unrealized losses		Fair Value	
	2005	2004	2005	2004	2005	2004	2005	2004
	(In thousands of US\$)							
Bonds	47,964	87,757	8,409	10,642	—	—	56,373	98,399
Total securities available for sale	<u>47,964</u>	<u>87,757</u>	<u>8,409</u>	<u>10,642</u>	<u>—</u>	<u>—</u>	<u>56,373</u>	<u>98,399</u>

c) *Income tax*

The provision for income taxes charged to the results of operations under US GAAP was as follows:

	Year ended December 31,		
	2005	2004	2003
	(In thousands of US\$)		
Current income tax expense	(1,261)	(970)	(481)
Deferred income tax expense	(24,074)	(33,109)	(17,879)
Total provision under US GAAP	<u>(25,335)</u>	<u>(34,079)</u>	<u>(18,360)</u>

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Deferred tax assets (liabilities) are summarized as follows:

	Year ended December 31,		
	2005	2004	2003
	(In thousands of US\$)		
Unearned income	(16,295)	(11,480)	(6,414)
Prepaid expenses	(6,100)	(7,405)	(5,256)
Property and equipment	(120,509)	(113,055)	(100,044)
Others	(916)	(689)	(3,563)
Gross deferred tax liabilities	(143,820)	(132,629)	(115,277)
Allowance for doubtful accounts	4,073	3,735	3,431
Tax loss carryforwards	33,282	46,752	62,535
Provision for vacations	2,732	2,517	1,994
Provisions for obsolescence of spare parts	4,593	3,814	2,499
Other	5,357	5,835	7,153
Gross deferred tax assets	50,037	62,653	77,612
Deferred tax assets valuation allowance	(10,988)	(10,803)	(7,498)
Net deferred tax liabilities	(104,771)	(80,779)	(45,163)

The provision for income taxes differs from the amount of income tax determined by applying the applicable Chilean statutory income tax rates of 17% (2005 and 2004) and 16.5% (2003) to pretax accounting income on a US GAAP basis as a result of the following differences:

	Year ended December 31,		
	2005	2004	2003
	(In thousands of US\$)		
Provision for income taxes at statutory Chilean tax rate Increase (decrease) in rates resulting from:	(30,298)	(33,113)	(17,683)
Non-taxable income	5,967	2,400	923
Non-deductible items	(334)	(271)	(258)
Change in valuation allowance	(185)	(3,305)	(2,053)
International income tax differences	(313)	548	800
Increase in Chilean tax rates (effect on deferred income tax)	—	—	(225)
Other	(172)	(338)	136
Provision for income taxes at effective tax rates	(25,335)	(34,079)	(18,360)

In accordance with Chilean law, the Company and each of its subsidiaries compute and pay taxes on a separate return basis and not on a consolidated basis.

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The Company and certain of the Chilean subsidiaries (principally Lan Cargo S.A.) have tax loss carryforwards aggregating ThUS\$ 120,024 at December 31, 2005 which have no expiration date. These tax losses have resulted in a deferred tax asset at that date of ThUS\$ 20,404.

Inversora Cordillera S.A. and its subsidiary have tax loss carryforwards aggregating ThUS\$ 13,911 at December 31, 2005 which have an expiration date of five years beginning in the first year that a loss is incurred. The related deferred tax asset was ThUS\$ 4,869 at December 31, 2005 and a 35% valuation allowance has been provided.

LanLogistics, Corp. and its subsidiaries have tax loss carryforwards aggregating ThUS\$ 11,085 at December 31, 2005 which have expiration dates of twenty years after the year of the loss. The related deferred tax asset is ThUS\$ 3,769 and a 100% valuation allowance has been provided because at the present time it appears unlikely that these tax losses will be utilized in future years.

Lan Chile Investment Limited and its subsidiaries have tax loss carryforwards aggregating ThUS\$ 6,964 at December 31, 2005 which have expiration dates between three and five years after the year of the loss. The related deferred tax asset is ThUS\$ 1,741 and a 100 % valuation allowance has been provided because at the present time it appears unlikely that these tax losses will be utilized in future years

Aerolinhas Brasileiras has tax loss carryforwards aggregating ThUS\$ 4,100 at December 31, 2005 which have no expiration date. However, a 100% valuation allowance has been provided against the related deferred tax asset of ThUS\$ 1,394 because at the present time it appears unlikely that these tax losses will be utilized in future years.

South Florida Air Cargo Inc. has tax loss carryforwards of ThUS\$ 3,226 at December 31, 2005 which have expiration dates of twenty years after the year of the loss. The related deferred tax asset was ThUS\$ 1,097 at December 31, 2005.

### *d) Fair value of financial instruments*

The following methods and assumptions were used to estimate the fair value of each class of financial instruments at December 31, 2005, 2004 and 2003 for which it is practicable to estimate that value.

#### *Cash, Time deposits and Marketable securities:*

Cash, time deposits and marketable securities are stated at their carrying amount, which is equivalent to fair value.

#### *Other assets:*

The fair value of long-term accounts receivable included within Other assets was estimated using the interest rate the Company would pay for similar credit.

#### *Short and long-term debt:*

The fair value of short and long-term debt was based on rates currently available to the Company for debt with similar terms and remaining maturities.

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### *Financial instruments:*

The fair value of swap fuel contracts (used in hedging of fuel prices) is the estimated amount that the Company would receive or pay to terminate the agreements at the balance sheet date taking into account current fuel prices and the current creditworthiness of the counterparties.

The fair value of the interest rate agreements is based on estimated mid-market valuations. Such mid-market values attempt to approximate the economic value at the balance sheet date of a position using prices and rates at the average of the estimated bid and offer for the respective underlying assets or reference rates and/or mathematical models, as deemed appropriate by the Company. In the absence of sufficient or meaningful market information, such valuations or components thereof may be theoretical in whole or in part.

The estimated fair values of the Company's financial instruments on a US GAAP basis are as follows:

	At December 31, 2005		At December 31, 2004	
	US GAAP Carrying amount	Fair Value (In thousands of US\$)	US GAAP Carrying amount	Fair Value
Cash	11,733	11,733	11,620	11,620
Time deposits	34,519	34,519	179,715	179,715
Marketable securities	121,392	129,801	123,932	134,497
Current portion of long-term loans	53,104	68,351	34,098	37,479
Current portion of other long-term obligations	45,687	52,209	51,725	55,555
Bank loans (long-term)	521,974	479,416	317,233	318,856
Other liabilities (long-term)	192,700	164,075	235,667	227,577
Financial instruments:				
Interest rate Derivatives	(10,472)	(10,472)	(19,913)	(19,913)
Swap fuel contracts	11,180	11,180	15,291	15,291

### *e) Concentration of credit risk*

The Company's accounts receivable are generated primarily from airline ticket and cargo service sales to individuals and various commercial enterprises that are economically and geographically dispersed, and the accounts receivable are generally short-term in duration. Accordingly, the Company does not believe that it is subject to any significant concentration of credit risk.

### *f) Financial instruments*

#### *Accounting for Derivatives and Hedging Activities*

All derivatives are recognized on the balance sheet at their fair value. On the date that the Company enters into a derivative contract, it designates the derivative as (1) a hedge of (a) the fair value of a recognized asset or liability or (b) an unrecognized firm commitment (a "fair value" hedge); (2) a hedge of (a) a forecasted transaction or (b) the variability of cash flows that are to be received or paid in connection with a recognized asset or liability (a "cash flow" hedge); (3) a foreign currency fair value or cash flow hedge (a "foreign currency" hedge); (4) a hedge of a net investment in a foreign operation; or (5) an instrument that is held for trading or non-hedging purposes (a "trading" or "non-hedging" instrument). Changes in the fair value of a derivative that is highly effective as, and that is designated and qualifies as, a fair value hedge, along with changes in the fair value of the hedged asset or liability that are attributable to the hedged risk (including changes that reflect losses or gains on firm commitments), are recorded in current period earnings. Changes in the fair value of a derivative that is highly effective as, and that is designated and qualifies as, a cash flow hedge, to the extent that the hedge is effective, are recorded in other comprehensive income, until earnings are affected by the variability of cash flows of the hedged transaction (e.g., until periodic settlements of a variable rate asset or liability are recorded in earnings).

Any hedge ineffectiveness (which represents the amount by which the changes in the fair value of the derivative exceed the variability in the cash flows of the forecasted transaction) is recorded in current period earnings. Changes in the fair value of a derivative that is highly effective as, and that is designated and qualifies as, a foreign currency hedge is recorded in either current period earnings or other comprehensive income, depending on whether the hedging relationship satisfies the criteria for a fair value or cash flow hedge. If, however, a derivative is used as a hedge of a net investment in a foreign operation, the changes in the derivative's fair value, to the extent that the derivative is effective as a hedge, are recorded in the cumulative translation adjustment account within other comprehensive income. Changes in the fair value of derivative trading and non-hedging instruments are reported in current period earnings.

Upon purchasing a financial instrument, the Company must determine whether a derivative instrument is "embedded" therein and if so, it must assess the economic characteristics of the embedded derivative to determine if they are clearly and closely related to the economic characteristics of the remaining component of the financial instrument (i.e., the host contract) and whether a separate, non-embedded instrument with the same terms as the embedded instrument would meet the definition of a derivative instrument. When it is determined that (1) the embedded derivative possesses economic characteristics that are not clearly and closely related to the economic characteristics of the host contract and (2) a separate, stand-alone instrument with the same terms would qualify as a derivative instrument, the embedded derivative is separated from the host contract, carried at fair value, and designated as either (1) a fair value, cash flow, or foreign currency hedge or (2) a trading or non-hedging derivative instrument. However, if the entire contract were to be measured at fair value, with changes in fair value reported in current earnings, or if the Company could not reliably identify and measure the embedded derivative for purposes of separating that derivative from its host contract, the entire contract would be carried on the balance sheet at fair value and not be designated as a hedging instrument.

The Company documents all relationships between hedging instruments and hedged items, as well as its risk management objective and strategy for undertaking various hedge transactions. This process includes linking all derivatives that are designated as fair value, cash flow, or foreign currency hedges to (1) specific assets and liabilities on the balance sheet or (2) specific firm commitments or forecasted transactions. The Company also formally assesses (both at the hedge's inception and on an ongoing basis) whether the derivatives that are used in hedging transactions have been highly effective in offsetting changes in the fair value or cash flows of hedged items and whether those derivatives may be expected to remain highly effective in future periods.

The Company discontinues hedge accounting prospectively when (1) it determines that the derivative is no longer effective in offsetting changes in the fair value or cash flows of a hedged item (including hedged items such as firm commitments or forecasted transactions); (2) the derivative expires or is sold, terminated, or exercised; (3) it is no longer probable that the forecasted transaction will occur; (4) a hedged firm commitment no longer meets the definition of a firm commitment; or (5) management determines that designating the derivative as a hedging instrument is no longer appropriate.

#### *Derivative instruments and hedging activities*

The Company's activities expose it to a variety of market risks, including risks related to the effects of changes in foreign-currency exchange rates, interest rates, and commodity prices. These financial exposures are monitored and managed by the Company as an integral part of its overall risk management program. The Company's risk management program focuses on the unpredictability of financial markets and seeks to reduce the potentially adverse effects that the volatility of these markets may have on its operating results.

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### *Financial instruments: fuel price risk management*

Jet fuel price fluctuations are largely dependent on supply and demand for crude oil in the world, OPEC decisions, refinery capacities, stock levels of crude and global political factors. In order to minimize the risk of jet fuel price fluctuations, the Company enters into swap and option contracts in the jet fuel market or the West Texas intermediate (WTI) market. The decision to enter into hedge contracts in the jet fuel or WTI market depends on the relative price of each commodity at the supposed trade date.

The Company enters into swap, call and put option contracts in order to fix or limit (depending on the case) the market price at a certain level for a given quantity of the above mentioned commodities. Pursuant to such contracts, the Company pays or receives, depending on the case, the difference between the agreed fixed price and the floating market price calculated on the notional amounts of such contracts. These contracts are classified as cash flow hedges for US GAAP purposes and as forecasted transactions for Chilean GAAP purposes.

As of December 31, 2005, the Company had some ineffectiveness with regard to its cash flow hedges of forecasted purchases of jet fuel outstanding as of year end. This ineffectiveness is based on the correlation of the projected market price of the underlying asset against the projected price of future fuel purchases. As of December 31, 2005, this ineffectiveness amounted to ThUS\$ 2,080 and was recorded in earnings for US GAAP purposes in 2005.

The notional fuel hedged, the realized results on such contracts and the fair value for the years ending December 31, 2005, 2004 and 2003 are as follows:

	2005	2004	2003
Hedged Gallons (million gallons)	176	118	134
Gain loss on fuel hedge contracts (ThUS\$)	51,480	46,529	12,302
Fair value of fuel hedge contracts (ThUS\$)	11,180	15,291	15,451

For Chilean GAAP purposes, gains and losses on the hedging contracts referred to above are recognized as a component of Other income (expense)-net when the underlying fuel being hedged is consumed. For US GAAP purposes, such gains and losses would be classified as Operating expenses under the caption Aircraft fuel when the fuel being hedged is consumed.

### *Financial instruments: Interest rate risk management*

The Company is exposed to the fluctuations of the LIBOR interest rates, due to the financing of certain aircraft. In order to reduce this exposure, the company decided to hedge a high percentage of its debt through the use of interest rate swaps and interest rate options.

In May 1999, the Company entered into an interest rate swap contract with a financial institution for a notional amount of ThUS\$ 50,000 to convert from floating rate (Libor based) to fixed rate for a period of five years. Pursuant to the contract, the Company pays or receives, depending on the case, the difference between the agreed fixed rate and the floating rate calculated on the notional amount of the contract. This contract expired in 2004. The loss on the contract during 2003 was ThUS\$ 1,531 and the fair value at December 31, 2003, was estimated at a loss of ThUS\$ 414. This swap did not qualify for a hedge relationship and accordingly was not designated as a hedge. Therefore, the fair value of the swap at December 31, 2003, of ThUS\$ (414), (ThUS\$ 1,945 at December 31, 2002) was charged to the results of operations for US GAAP purposes instead of as a charge to Other comprehensive income (loss) (see paragraph 1 m).

In May 2001 the Company also entered into six receive-floating, pay-fixed interest rate swap contracts in order to hedge the variable interest payments on existing debt of ThUS\$ 330,608. Pursuant to these contracts, the Company pays or receives, depending on the case, the difference between the agreed

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fixed rate and the floating rate calculated on the notional amount of each contract. There is no associated cost to these contracts. The critical terms of these swap contracts, namely notional amounts and dates, have been negotiated to match the terms of the designated variable-rate debt; therefore, there is no ineffectiveness. Additionally, during October 2005, the Company entered into two interest rate swap contracts in order to hedge the Libor exposure of the financing of two A319-100 aircraft delivered in 2005.

The fair value and the losses of these swap contracts for the years ending December 31, 2005, 2004 and 2003, are as follows:

	2005	2004	2003
Losses on interest rate swap contracts (ThUS\$)	(5,783)	(10,969)	(12,837)
Fair value of interest rate swap contracts (ThUS\$)	(4,719)	(13,608)	(22,840)

During July 2003, the company entered into four interest rate cap contracts for a total notional amount of ThUS\$ 127,753. These caps are intended to limit the Company's exposure arising from variable-rate debt. Under Chilean and US GAAP, these contracts qualify as cash flow hedges with no ineffectiveness associated to them due to the fact that all critical terms of the debt and the caps match perfectly. The fair value of these contracts has been estimated at ThUS\$ 1,315.

During the same month, the Company entered into an additional two interest rate cap contracts. These caps are intended to limit the exposure of LIBOR-linked operational lease payments on aircraft received during 2004. The fair value of these contracts at year end amounted to ThUS\$ 804.

During April 2004, the Company entered into an additional two interest rate cap contracts. These caps are intended to limit the exposure of LIBOR-linked operational lease payments on aircraft received during 2005. The fair value of these contracts at year end amounted to ThUS\$ 246.

During 2005, the Company entered into three additional interest rate Cap contracts. These contracts are intended to limit the exposure of LIBOR-linked financing on two aircraft delivered in 2005 and one to be delivered in 2006. The fair value of these contracts at year end amounted ThUS\$ 268.

Under FAS 133, these derivatives qualify as cash flow hedges even though some ineffectiveness exists as the notional amount over which some caps are calculated is different from the one used to determine the interest and lease payments on the aircraft. However, this ineffectiveness is not recorded in earning because was not considered to be significant. Under Chilean GAAP, the caps are accounted for as cash flow hedges and no ineffectiveness was determined.

At December 31, 2005, the Company had not received payment from any of the eleven aforementioned caps. The premium on the caps is being amortized throughout the term of each contract for Chilean and US GAAP purposes.

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In April 2002, the Company entered into a Treasury rate lock for a notional amount of ThUS\$ 45,000 in order to “lock in” a desired interest rate and hedge the variability in the cash proceeds attributable to changes in the benchmark interest rate to be received from the forecasted securitization of future credit card receivables originating from certain ticket agents in the United States, as described in Note 16 to these financial statements. The contract was classified as a cash flow hedge of a forecasted transaction for US GAAP purposes and as a hedge of an forecasted transaction for Chilean GAAP purposes.

The forecasted transaction referred to above occurred on August 22, 2002. At that time the Company recognized a deferred loss of ThUS\$ 3,622 under Chilean GAAP for the settlement of the Treasury rate lock contract. During 2002 and for US GAAP purposes, the Company recognized a net loss of ThUS\$ 402 which represented the total ineffectiveness of the cash flow hedge of the forecasted securitization and debited Other comprehensive income for the remaining ThUS\$ 3,219, which is being amortized over the life of the securitization contract (82 months). During 2005, the Company recognized an amortization charge for this concept amounting to ThUS\$ 471 under US GAAP, (ThUS\$ 471 during 2004 and ThUS\$ 471 during 2003). The deferred loss on the hedging contract referred to above is included in the balance sheet under the captions Prepaid expenses and Other assets (current and non-current portions, respectively) and the corresponding amortization is included in Interest expense both for Chilean and US GAAP purposes. The effect of recording the ineffectiveness of cash flow hedge (net of amortization) in accordance with US GAAP is included in paragraph l m) above.

As a result of those hedging activities, the Company has 87.5% of its interest rate exposure hedged.

### *Financial instruments: foreign currency exchange rates*

The company conducts business in local currencies in several countries and accordingly faces the risk of variation in foreign currency exchange rates. A depreciation of the Chilean peso, the Brazilian real, Argentine peso, Mexican nuevo peso, Peruvian nuevo sol or the European euro against the U.S. dollar could have a material adverse effect on the Company because it has revenues and receivables denominated in those currencies. As a part of its risk management policy, the Company regularly monitors its exposure to variations in the exchange rates of these different currencies. In order to reduce the impact of the foreign exchange rate fluctuations, the Company enters from time to time into foreign exchange hedging contracts. Under these forward contracts, for any rate above or below the fixed rate, the Company receives or pays the difference between the spot rate and the fixed rate for the given amount at the settlement date.

As of December 31, 2005 and 2004, the Company has no outstanding exchange forward contracts for hedging purposes.

In order to have a better yield on its investments in 2004, the Company entered into bank deposits in Chilean Peso together with a US dollar-Chilean pesos foreign exchange swap in order to receive US dollars at maturity. The mark to market value of these foreign exchange swaps amounted to a loss of US\$ 1.9 million and is recorded in earnings under both Chilean and US GAAP.

### *Other information on derivative instruments*

By using derivative financial instruments to hedge exposures to changes in exchange rates, interest rates, and jet fuel prices, the Company exposes itself to credit risk and market risk.



Credit risk is the risk that the counterparty might fail to fulfill its performance obligations under the terms of the derivative contract. When the fair value of a derivative contract is positive, the counterparty owes the Company, which creates repayment risk for the Company. When the fair value of a derivative contract is negative, the Company owes the counterparty and, therefore, does not assume repayment risk. The Company minimizes its credit (or repayment) risk in derivative instruments by (1) entering into transactions with high-quality counterparties (2) limiting the amount of its exposure to each counterparty, and (3) monitoring the financial condition of its counterparties. The Company also maintains a policy of requiring that derivative contracts be governed by an ISDA Master Agreement. Market risk is the risk that the value of a financial instrument might be adversely affected by a change in interest rates, currency exchange rates, or jet fuel prices. The Company manages the market risk associated with interest rate, jet fuel price, and foreign-exchange contracts by establishing and monitoring parameters that limit the types and degree of market risk that may be undertaken.

*g) Comprehensive income (loss)*

Comprehensive income (loss) is the change in equity of a business enterprise during a period from transactions and other events and circumstances from non-owner sources. The fair value of cash flow hedges were considered to be Other comprehensive income during 2005, 2004 and 2003 and the unrealized gain on available for sale securities has been included in 2005.

*h) Recent Accounting Pronouncements*

In May, 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections". Accounting Principles Board Opinion 20 previously required that most voluntary changes in accounting principles be recognized by including in net income of the period of the change the cumulative effect of changing to the new accounting principle. This Statement requires retrospective application to prior periods' financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. When it is impracticable to determine the period-specific effects of an accounting change on one or more individual prior periods presented, this Statement requires that the new accounting principle be applied to the balances of assets and liabilities as of the beginning of the earliest period for which retrospective application is practicable and that a corresponding adjustment be made to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that period rather than being reported in an income statement. When it is impracticable to determine the cumulative effect of applying a change in accounting principle to all prior periods, this Statement requires that the new accounting principle be applied as if it were adopted prospectively from the earliest date practicable.

In February 2006, the FASB issued Statement of Financial Accounting Standards No. 155 "Accounting for Certain hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140". This Statement amends FASB Statements No. 133, Accounting for Derivative Instruments and Hedging Activities, and No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. This Statement resolves issues addressed in Statement 133 Implementation Issue No. D1, "Application of Statement 133 to Beneficial Interests in Securitized Financial Assets. This Statement permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, clarifies which interest-only strips and principal-only strips are not subject to the requirements of Statement 133, establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation, clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives and amends Statement 140 to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. This Statement is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006.

Subsidiaries

<u>Legal Name</u>	<u>Place of Incorporation</u>	<u>Doing Business As</u>	<u>Ownership %<sup>1</sup></u>
Lan Cargo S.A.	Chile	Lan Chile Cargo	99.85%
Aircraft International Leasing Limited	Bahamas	AILL	99.98%
Transporte Aéreo S.A.	Chile	LanExpress	99.9%
Seagull Leasing LLC	Delaware, USA	Seagull	100%
South Florida Air Cargo	Florida, USA	Southflorida	100%
Bluebird Leasing LLC	Delaware, USA	Bluebird	100%
Lan Logistics Corp.	Delaware, USA	Lanlogistics	100%
Lan Cargo Overseas Services Limited	Bahamas	Lan Cargo Overseas	100%
Lan Perú S.A.	Peru	Lan Perú	49%
Inversiones Lan S.A.	Chile	Inverlan	99.7%
Inmobiliaria Aeronáutica S.A.	Chile	Inmobiliaria Aeronáutica	99.01%
Lan Pax Group S.A.	Chile	Lan Pax Group	99.83%

<sup>1</sup> Ownership percentage of direct owner of each significant subsidiary of Lan Airlines S.A.

**Certification of Chief Executive Officer**

I, Enrique Cueto Plaza, certify that:

1. I have reviewed this annual report on Form 20-F of Lan Airlines S.A.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the company as of, and for, the periods presented in this report;
4. The company's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the company and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the company, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Evaluated the effectiveness of the company's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (c) Disclosed in this report any change in the company's internal control over financial reporting that occurred during the period covered by the annual report that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting; and
5. The company's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the company's auditors and the audit committee of the company's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the company's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the company's internal control over financial reporting.

Date: June 30, 2006

By: /s/ Enrique Cueto Plaza

Name: Enrique Cueto Plaza

Title: Chief Executive Officer

**Certification of Chief Financial Officer**

I, Alejandro de la Fuente, certify that:

1. I have reviewed this annual report on Form 20-F of Lan Airlines S.A.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the company as of, and for, the periods presented in this report;
4. The company's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the company and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the company, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Evaluated the effectiveness of the company's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (c) Disclosed in this report any change in the company's internal control over financial reporting that occurred during the period covered by the annual report that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting; and
5. The company's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the company's auditors and the audit committee of the company's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the company's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the company's internal control over financial reporting.

Date: June 30, 2006

By: /s/ Alejandro de la Fuente Goic

Name: Alejandro de la Fuente Goic

Title: Chief Financial Officer

**Officer Certifications**  
**Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002**

Pursuant to section 906 of the Sarbanes-Oxley Act of 2002 (subsections (a) and (b) of section 1350, chapter 63 of title 18, United States Code), each of the undersigned officers of Lan Airlines S.A. (the “Company”), does hereby certify to such officer’s knowledge that:

The annual report on Form 20-F for the year ended December 31, 2005 (the “Form 20-F”) of the Company fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934 and information contained in the Form 20-F fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: June 30, 2006

/s/ Enrique Cueto Plaza

Name: Enrique Cueto Plaza

Title: Chief Executive Officer

Dated: June 30, 2006

/s/ Alejandro de la Fuente Goic

Name: Alejandro de la Fuente Goic

Title: Chief Financial Officer

A signed original of this written statement required by Section 906 has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.