WILLIAMS MULLEN

Direct Dial: 202.293.8135
barden@williamsmullen.com

October 3, 2007

**BY ELECTRONIC TRANSMISSION**

Ms. Marlene H. Dortch, Secretary
Federal Communications Commission
Office of the Secretary
445 12th Street, S.W.
Washington, DC 20554

Re: Notice of Oral Ex Parte Presentations in Connection With the Consolidated Application for Authority to Transfer Control in Connection With the Sirius/XM Merger, as Amended (MB Docket No. 07-57)

Dear Ms. Dortch:

On October 3, 2007, the undersigned and Julian L. Shepard of Williams Mullen, and Messrs. J. Gregory Sidak and Hal J. Singer of Criterion Economics, L.L.C., representing the Consumer Coalition for Competition in Satellite Radio ("C3SR"), met with the following FCC staff members: Marcia Glauberman, Roy Stewart, Bill Freedman, Rosalee Chiara, Marilyn Simon, Joel Rabinovitz, Dan Bring, Jerry Duvall, Elvis Stumbergs, George Williams, Dana Scherer, Tracy Waldon, Royce Scherlock, Ann Bushmiller, Judith Herman, David Strickland, Jim Bird, and Gregory Crawford. The purpose of the meeting was to discuss C3SR's concerns with the proposed merger of XM Satellite Radio Holdings Inc. ("XM") and Sirius Satellite Radio Inc. ("Sirius") and the above-referenced application.

C3SR presented a summary of Professor Sidak's critique of the recent submission by CRA International on behalf XM and Sirius, as well as C3SR's grounds for opposition to the merger as set forth in its Petition to Deny and in the Declarations of Professor Sidak in this proceeding. C3SR's presentation is summarized in the attached document, entitled "Analysis of the CRA Submission," produced by Messrs. Sidak and Singer.

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Pursuant to Section 1.1206 of the Commission's Rules and DA-07-1435, this letter is submitted via ECFS for inclusion in the public record of these proceedings, with an email copy to the above-mentioned meeting participants.

Respectfully submitted,

Benjamin D. Arden
Counsel to C3SR

Attachment
cc (by email):

Marcia Glauberman
Roy Stewart
Bill Freedman
Rosalee Chiara
Marilyn Simon
Joel Robinovitz
Dan Bring
Jerry Duvall
Elvis Stumbergs
George Williams
Dana Scherer
Tracy Waldon
Royce Sherlock
Ann Bushmiller
Judith Herman
David Strickland
Jim Bird
Gregory Crawford

# Analysis of the CRA Submission

J. Gregory Sidak, Georgetown University Law Center
Hal J. Singer, Criterion Economics

# Overview

- CRA's Arguments on Market Definition
- Profitability of Commercial Increase
- CRA's "Dynamic Demand" Arguments
- Proposed A La Carte Offering

# Market Definition in a High-Tech Era

- "No substantial changes to merger enforcement policy are necessary to account for industries in which innovation, intellectual property, and technological change are central features."
  - Antitrust Modernization Commission (April 2007)

# Demand-Side Evidence Required (1 of 2)

- "Market definition focuses *solely* on demand substitution factors—i.e., possible consumer responses. Supply substitution factors—i.e., possible production responses—are considered elsewhere in the Guidelines in the identification of firms that participate in the relevant market and the analysis of entry."
  - *Merger Guidelines* § 1.0

# Demand-Side Evidence Required (2 of 2)

- "Product market definition depends critically upon demand-side substitution—i.e., consumers' willingness to switch from one product to another in reaction to price changes. The Guidelines' approach to market definition reflects the separation of demand substitutability from supply substitutability—i.e., the ability and willingness, given existing capacity, of firms to substitute from making one product to producing another in reaction to a price change."
  - *Merger Guidelines Commentary* § 1 (2006)

# An Economist's Definition of Substitution

- Demand substitutes: Buyers of *A* shift demand to *B* in response to increase in price of *A*
- Supply substitutes: Sellers of *B* shift a portion of capacity to production of *A* in response to an increase in the price of *A*
  - Carlton & Perloff, Modern Industrial Organization

# What Is the Logic of the *Guidelines*?

- Elasticity of demand is a summary statistic that addresses the SSNIP test
- Supply substitution cannot be counted on to constrain prices in the short run
- Entry informs market power within a given product market, not market definition
- "The approach taken by the Merger Guidelines is preferable because it can be both difficult and confusing to ask one analytical step, market definition, to account for two economic forces, demand and supply substitution."
    - Jonathan Baker, Antitrust Law Journal (2007)

# CRA's Information About Substitution

- Anecdotes of what suppliers of alternative audio devices have been doing, allegedly in response to entry by SDARS providers
- Says <u>nothing</u> about how consumers would react to a SSNIP

# CRA's Activation/Deactivation Data

- When users activate (deactivate) an SDARS subscription, the share of their total minutes spent listening to terrestrial radio decreases (increases)
  - Listeners do not activate (deactivate) an SDARS subscription in response to a relative change in the price of SDARS to terrestrial radio

# CRA's SDARS Penetration Regression

- SDARS penetration is higher in markets with fewer terrestrial radio stations
  - Relative price of terrestrial to SDARS does not vary across observations
  - Number of stations is not a proxy for quality
  - In the absence of control variables, number of stations likely serves a proxy for size
- XM and Sirius refused our request to supply underlying data used in regression

# An Example of CRA's Irrelevant Supply-Side Data

- Content providers for iPods/MP3s make available a wide variety of audio content, including "Internet radio" programs
  - Efforts are likely aimed at selling high-margin, complementary services to iPod users
  - Not motivated by expected demand response to change in relative prices
  - Not evidence of shifting capacity to SDARS

# CRA's Erroneous Demand-Side "Evidence"

| *Alleged Source of Price Constraint for SDARS* | *Demand-Side Evidence* | *Does the Evidence Capture Actual Buyer Substitution in Response to a Relative Change in Prices or Quality-Adjusted Prices?* |
|---|---|---|
| Terrestrial Radio | • When users *activate* an SDARS subscription, the *share* of their total minutes listening to terrestrial radio decreases<br>• When users *deactivate* an SDARS subscription, the *share* of their total minutes listening to terrestrial radio increases<br>• SDARS penetration is higher in markets with fewer terrestrial radio stations<br>• All SDARS subscribers were former terrestrial radio subscribers | • No<br>• No<br>• No<br>• No |
| iPods and MP3 Players | • More former XM subscribers listen to iPods or MP3 players than to Sirius<br>• SDARS sales projections are decreasing at the same time that sales of iPods and MP3 players are increasing | • No<br>• No |
| Mobile Telephones | • **None** | • NA |
| Mobile Internet | • **None** | • NA |

# CRA's Erroneous Supply-Side "Evidence"

| *Alleged Source of Price Constraint for SDARS* | *Supply-Side Evidence* | *Does the Evidence Capture Potential Buyer Substitution in Response to a Relative Change in Prices or Quality-Adjusted Prices?* |
|---|---|---|
| Terrestrial Radio | • Terrestrial radio stations have reduced the number of commercials, repackaged their music, and introduced HD radio | • No |
| iPods and MP3 Players | • Content and service providers for iPods and MP3 players make available a wide variety of audio content, including Internet radio programs | • No |
| Mobile Telephones | • Most mobile telephone carriers offer audio content-enabled phones | • No |
| Mobile Internet | • Internet offerings for the car are becoming more robust | • No |

# Profitability of an Increase in Commercial Time (1 of 4)

- Sirius post-merger objective: "would like to see advertising revenue eventually make up about 10% of Sirius' total revenue, up from the current 4% to 5%."
    - Louis Hau, *Sirius CEO Discusses The Biz*, Forbes.com, Sept. 17, 2007 (quoting Mel Karmazin)

# Profitability of an Increase in Commercial Time (2 of 4)

- Profits with more commercials will exceed profits without commercials whenever
  - $[a\ t + P]\ Q\ k(t) - C > P\ Q - C$,
    - $Q$ = the number of SDARS subscribers
    - $P$ = the monthly subscription price
    - $C$ = the costs of operating the SDARS network
    - $a$ = the monthly advertising revenue per customer expressed on a per minute per hour basis
    - t = number of minutes of commercials per hour
    - $k(t)$ = the percentage of SDARS customers who retain their subscription in spite of an increase of $t$ commercials per minute

# Profitability of an Increase in Commercial Time (3 of 4)

# Profitability of an Increase in Commercial Time (4 of 4)

- Key takeaways
  - When *a* is $0.50, the SDARS provider is roughly indifferent between adding and not adding three minutes of commercials when subscribers attribute 30 percent of the value of SDARS to commercial avoidance
    - An increase of two minutes of commercials per hour is profitable, whereas an increase of four minutes of commercials per hour is not profitable.
  - Indeed, when *a* is $1.50, the SDARS provider would be indifferent between adding and not adding five minutes of commercials to its lineup when subscribers attribute 50 percent of the value of SDARS to commercial avoidance—despite the fact that 36 percent of its customers would terminate their subscription.

# CRA's Assault on the SSNIP Test: "Dynamic Demand"

- Traditional SSNIP test should be altered to account for "dynamic demand"
  - Unprecedented
  - Wholly theoretical: What are the necessary conditions?
  - Would vitiate the traditional SSNIP test

# CRA's Use of "Dynamic Demand" as an Efficiency Justification

- *Claim*: DD spillover encourages free riding by XM and Sirius, which undermines each provider's incentive to engage in "demand-enhancing investments"
  - If there is a new incentive post-merger to engage in promotion, then iPods et al do not compete with SDARS; else post-merger "demand-enhancing" investments would generate demand for iPods et al
- *Claim*: Elimination of DD spillover would accelerate the introduction of interoperable radios
  - Interoperability would decrease switching costs
  - No free-rider problem whenever both firms shared the costs of developing interoperable device equally

# A La Carte Offering

- Not merger-specific
- No proof of significant demand for "Howard-free" offering
- Pledge *not* to offer a la carte in the absence of merger approval is per se violation of section 1
  - Merger approval process provides XM and Sirius forum in which to coordinate their future pricing strategies <u>if the merger is rejected</u>.

# Conclusions

- A merger to monopoly
- XM and Sirius have failed to introduce credible evidence that
  - product market should be defined more broadly
  - efficiency gains offset anticompetitive effects
  - the remedies proposed would mitigate monopoly power
- The FCC should deny the application