Does The Lack of Inter-operable Radios Mean Less Competition And Monopoly Power?

The Carmel Group's Continuing Opposition To The Proposed Sirius-XM Satellite Radio Merger

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The Carmel Group was retained by the National Association of Broadcasters to review the proposed merger, given our company's lengthy history of providing independent and objective analysis of critical global telecommunications issues.

[1] Note that in addition to The Carmel Group's 2002-2003 involvement in the proposed merger between EchoStar and DirecTV (which largely involved supplying data to the government showing that substantial competition existed between EchoStar and DirecTV), The Carmel Group has also written two other studies on behalf of the NAB in opposition to the proposed Sirius-XM merger, in April 2007 and in October 2007. Both may be accessed by going to The Carmel Group's website at *www.carmelgroup.com*. A third study, done independently and entitled the "2-Buck-Chuck Test," may also be accessed by visiting the "publications" page on The Carmel Group's website.

TABLE OF CONTENTS

"We will give people more choice than they had before and lower prices and less confusion."
- Sirius CEO, Mel Karmazin, on February 28, 2007, before the U.S. House Judiciary Committee Antitrust Task Force [2]

Executive Summary

- Recently, as it relates to arguments that apparently support the proposed merger of Sirius Satellite Radio (Sirius) and XM Satellite Radio (XM), a strange message has entered the public forum: *because Sirius and XM never met their obligation to develop radio receivers that could receive both services (i.e., the so-called inter-operable satellite radios), there is inadequate competition between Sirius and XM to support the government's antitrust opposition.* [3]
- This non-sequitur attempts to further break the universe of current subscribers and would-be subscribers into two distinct and separate bodies of satellite radio subscribers. Acknowledging that strong competition exists between Sirius and XM for **new** (i.e. would-be) subscribers, this odd argument instead focuses on **current** satellite radio subscribers.
- Focusing on these **current** subscribers, this argument maintains that if the barriers in front of changing to a competitive provider are so high that the current subscriber is essentially kept from switching to a competitor, then the two operators do not actually compete for current subscribers. By not timely developing and distributing an inter-operable radio (thus easing those barriers), the argument goes, Sirius and XM showed a lack of competition between them.
- This perplexing argument finally posits that preventing Sirius and XM from merging would thus not gain anything for consumers (because the two providers already have minimal competition between them, at least as it relates to current subscribers). It is then argued that the U.S. Department of Justice's (DOJ) and the Federal Communication Commission's (FCC) opposition to the proposed merger is not warranted, *because permitting a merger would have little ill effect on the consumer in the marketplace.*
- Yet, the truth lies clearly elsewhere. Unfortunately for Sirius' and XM's ill-advised attempt to become a monopoly – and as each of The Carmel Group's prior three studies have clearly exhibited – ***the satellite radio duopolists do compete, vigorously, for both new and current subscribers.*** As this study shows below, *the real truth is that the failure to date of Sirius and XM to develop an inter-operable radio has occurred primarily because of the opposite of what this quirky argument posits.* **Indeed, <u>the lack of an inter-operable</u>**

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[2] Mr. Karmazin's comments are compared to those of the current administration's Federal Trade Commissioner, Deborah Platt Majoras, who, on March 8, 2007, during *NBC Nightly News With Brian Williams,* stated: **"What benefits you as a consumer is a competitive marketplace. And when these companies are entering into these agreements, they're trying to take out the competitive aspect."** (Note, Ms. Majoras was not specifically addressing the Sirius-XM merger.)

[3] This point in the opening paragraph assumes that either Sirius or XM could build and distribute an inter-operable radio alone, as a pure competitor, yet obviously, with inter-operable radios, both Sirius and XM would have to work closely and extensively together to achieve success.

<u>radio occurs at best because of intense existing competition between Sirius and XM, or at worst because of premeditated collusion.</u> [4]

- Where commercial parties have engaged in clear anti-competitive behavior which impairs competition -- especially in a duopoly market place -- the government should absolutely refrain from providing a safe harbor from antitrust enforcement.
- *The integrity of the pro-merger "no inter-operability = no competition" argument would never be considered in any other market.* Would the DOJ permit Ford and GM to combine based upon their assertion that a lack of an inter-operable automobile, or the cost burden to switch from a Ford Explorer to a Chevy Suburban, equates to a lack of competition between them? Perhaps most importantly, ***the Sirius-XM merger's precedent-setting implications are vast and could establish a lightning round of similar anti-competitive proposals, in every industry.***
- Sirius' and XM's pattern of repeated bad faith, as well as an inability to show good intentions toward the government and consuming public, and its lack of follow-through time and again, are further reasons to distrust their claims and representations, and to not reward them for such bad acts, including that of their concerted efforts <u>not</u> to timely develop and distribute an inter-operable radio.

Discussion

- **<u>Background</u>:** To help understand this issue, it is necessary to add some brief, yet essential, background. [5] The reader is advised to read footnote number 5 below for this perspective.
- **<u>Long Over Due</u>:** In mid-2003, then Sirius CEO Joe Clayton told a public audience that they should expect the inter-operable receivers to be developed in a timeframe of "2-3 years." This implies that had Sirius and XM wished to succeed in their efforts to develop an inter-operable receiver by February 2007 (which is the time of the Sirius-XM announcement of the proposed merger, almost four years following Mr. Clayton's comments, and almost ten years after the original 1997 FCC mandate to develop inter-operable radios), they

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[4] For the best example in today's market place of existing competition between Sirius and XM, as it relates to both new (i.e., would-be) and current subscribers, go directly to the following link: *<u>http://carmelgroup.com/publications/document/competition_belied_opposition_to_the_proposed_sirius_xm_merger/</u>*

[5] A brief description of the **background** behind the issue of inter-operable radios goes back to the earliest days of satellite radio and its formation. When they were first formed in the mid-to-late 1990s, satellite radio operators Sirius (then called CD Radio) and XM (filing under the name American Mobile Radio Corporation (AMRC)) were asked by the FCC to work diligently toward the creation of an inter-operable radio, i.e., one that could receive either and both XM and Sirius via the same hardware device. The FCC did this according to its 1997 SDARS Order, 12 F.C.C.R. 5754, 12 FCC Rcd. 5754, 6 Communications Reg. (P&F) 978, 1997 WL 93894 (F.C.C.) Federal Communications Commission (F.C.C.), **Report and Order Memorandum Opinion and Order and Further Notice of Proposed Rulemaking,** IN THE MATTER OF ESTABLISHMENT OF RULES AND POLICIES FOR THE DIGITAL AUDIO RADIO SATELLITE SERVICE IN THE 2310-2360 MHZ FREQUENCY BAND, IB Docket No. 95-9, GEN Docket No. 90-357, RM No. 8610, PP-24, PP-86, PP-87, **FCC 97-70, Adopted: March 3, 1997, Released: March 3, 1997,** because, in the FCC's own words, "By promoting receiver inter-operability for satellite DARS, we are encouraging consumer investment in satellite DARS equipment and creating the economies of scale necessary to make satellite DARS receiving equipment affordable. This rule also will promote competition by reducing transaction costs and enhancing consumers' ability to switch between competing DARS providers." Yet, the obligation had one fatal flaw: the FCC never created a deadline. Thus, in the more than ten years since the release of this FCC "Report and Order," the two operators spent no more than a modest sum (i.e., approximately $25 million between them both), met only occasionally and half-heartedly to progress, and realized early on that the downside of merging radio devices for both of them was much greater than the upside.

would have. Indeed, today, if they truly wished to distribute an inter-operable radio, this could be accomplished by Sirius and XM in about six months' time, according to several closely placed and highly reliable sources contacted by The Carmel Group. Thus, primarily for strategic reasons, both Sirius and XM chose not to progress quickly toward development and deployment of the inter-operable radio.

- **Reasons For Delay:** Indeed, there are a handful of important reasons behind the failure of Sirius and XM to combine together to actually build and market an inter-operable satellite radio during the prior nearly 11 years since first directed to do so by the FCC in 1997. These include 1) competitive concerns, 2) technical concerns, 3) confusion among various parties as to the actual implementation of inter-operable radios and what that would mean to them, [6] and 4) the inability of the parties to invest adequately of their time and resources. (Note that this failure of Sirius and XM to properly invest, includes both the ultimate *cost* to develop and distribute such inter-operable radios, and the fact that both companies early on were struggling to survive financially, and literally *dozens of things were deemed more important.*)
- **Competitive Start Times:** Had Sirius and XM been able to start their respective operations at the same time (meaning both launched their satellites and had their on-the-ground hardware operational), their receptivity toward an inter-operable radio would have been much greater. Yet, because XM was able to get the combination of its satellites and on-ground-hardware in place eight months sooner than rival Sirius, Sirius was at a substantial disadvantage during the first few years of the satellite radio competition.
- **Why Help The Competitor?** Thus, especially from XM's point of view, it would have been extremely counter-productive to have allowed its current subscribers to easily migrate to Sirius. Put another way, XM had no reason to let Sirius off the mat in the fierce wrestling match it was clearly winning during the first 3-5 years of the rivalry. Once XM saw Sirius spending much more than XM to develop superior content in every content category -- across the board -- XM had even less incentive to develop an inter-operable radio. On Sirius' side, as its spending to acquire new subscribers and catch up with XM increased, and Sirius' Subscriber Acquisition Costs (SAC) rose, Sirius, too, had even less incentive to develop an inter-operable radio. Why spend a ton on great content and on acquiring subscribers, only to risk quickly losing them – and their rich Average Revenue Per Unit (ARPU) -- to a competitor via an inter-operable radio? [7] This, then, is the true nature of Sirius' and XM's ridiculous delay in the development of the inter-operable radio.
- **Valuable Subscribers:** In addition to competing over **current** subscribers, a huge sum of what Sirius and XM do today is to compete for **new** (or would-be) subscribers. A newly acquired subscriber means not only overall system subscriber growth and market share (that both Sirius and XM can separately tout to investors and to Wall Street); a new subscriber also means significant ARPU, which is a critical marker of financial success. Plus, a newly acquired subscriber is almost always a subscriber that cannot be acquired by the competition, because an extremely small number of satellite radio subscribers today subscribe to *both*

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[6] For example, the automobile Original Equipment Manufacturers (OEMs) were concerned as to just how the long-term revenue streams they relied on from the satellite radio operators' consumers' would be impacted by those consumers being able to switch off their existing service and switch into a competitive service, especially if that OEM had no agreement with the other competitive satellite radio service (i.e., the one with which it had not contracted).

[7] For example, according to both companies' most recent press releases and/or federal filings covering ARPU and SAC, both of which can be accessed on their respective websites, i.e., www.xmradio.com and www.sirusradio.com, XM's monthly **ARPU** as of 3d Q '07 amounted to $10.17 (or $122.04 annually); Sirius' monthly ARPU as of 3d Q '07 came in at $10.71 (or $128.52 annually). **SAC** for the same period amounted to $116 for XM and $103 for Sirius. The point here: *current subscribers are costly, and therefore cherished, and not easily relinquished, e.g., via giving them inter-operable radios.*

services. In short, neither Sirius nor XM had any incentive (other than a vague and avoidable governmental mandate) to empower the consumer to move easily from one service to another, especially in light of the up-front SAC investment, and the ARPU expected from each current subscriber, the latter of which markedly increases the longer the current subscriber stays longer with the service. In the subscription content business, a "sticky" consumer is truly the name of the game, and inter-operable radios certainly do nothing to achieve that goal.

- **Inter-operable = Losses:** In sum, neither Sirius nor XM has yet ever truly wished to fulfill the requirement of the FCC toward inter-operable radios. Thus, no one who understands the satellite radio marketplace (both yesterday and today) would seriously contend that the more-than-ten-year failure of Sirius and XM to deliver consumers an inter-operable radio had anything to do with anything except each operator's true desire to remain competitive and to deny competitive opportunities to the competitor. By offering up an inter-operable radio, both XM and Sirius would be, in essence, giving the extremely valuable current subscriber low thresholds to exit his/her existing subscription, making it easy to migrate from one platform to the other, and to try out the competition. This is the only real reason behind Sirius' and XM's delay and implied opposition to timely implementation of the FCC's inter-operable radio mandate of 1997.
- **Key Technical Concerns:** As it relates to technical concerns, development of a universal antenna, serving two different satellite constellations, and offering a unified set of integrated circuits (ICs), has been a key obstacle, as well as the development of a unified Radio Frequency (RF) tuner and module(s). Nonetheless, universal opinions from those close to the technical side of the inter-operable radio issue support the notion that an inter-operable radio was an eminently doable project, had the parties wanted it done. Indeed, had they wanted it done, there is no way it would *ever* had taken more than 11 years to implement.
- **Half-Hearted Response:** Both Sirius and XM gave implementation of the inter-operable radio standard no more than lip service. (See, Sirius-XM joint press release of February 16, 2000, together with Sirius' 10K filing of 2006, wherein Sirius warns investors that "Non-compliance by us with these conditions could result in fines, additional license conditions, license revocation or other detrimental FCC actions." Yet, in light of the eight years that have transpired since this first statement, coupled with the near absolute dearth of information about or actual evidence of any true progress toward a consumer inter-operable radio, one can't help but wonder at the actual good faith of either satellite radio operator toward this goal.
- **Bad Examples, Bad Precedence:** The inappropriateness of the pro-merger "no inter-operability = no competition" argument is further emphasized by a common sense comparison to that of automobile consumers (as but one of many possible examples). Would the DOJ permit Ford and GM to combine based upon their assertion that a lack of an inter-operable automobile, or the cost burden to switch from a Ford model to a similar Chevy model, equates to a lack of competition? Can you imagine such an argument or result? To permit such an argument would make a mockery of antitrust laws and enforcement, meaning similar unthought-of combinations would become commonplace. Indeed, this merger's precedent-setting implications are huge, and could set up a quick succession of similar proposals, starting with Microsoft and Yahoo, and continuing on endlessly to include Comcast and Time Warner, as well as DirecTV and EchoStar, among hundreds of others. One can't help but worry about the impact on the consumer.

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- **Bad Faith, Inappropriate Reward:** As noted in The Carmel Group's first study, completed in April 2007, a strong argument can be made that either together or apart, these satellite radio companies cannot be trusted. Both have been bad actors. For instance, they have repeatedly acted to intentionally interfere with broadcast stations' frequencies and consumers' clear reception of broadcast signals; they have ignored a government requirement that they manufacture and distribute consumer-friendly inter-operable radios; and they have ignored the oversight authority of the FCC. [8] What assurances can the same management team provide that under a single monopoly management it will not, even more aggressively, push its own selfish motives to the detriment of the overall public good? Moreover, granting this merger would then be perceived as a form of government reward for such bad acts.
- **Antitrust Enforcement:** XM and Sirius argue that a merger will not cause anti-competitive effects, because few subscribers switch from one service to the other. But this is due to their own (perhaps coordinated) failure to produce consumer friendly, inter-operable radios. Government should not reward duopolists with a safe harbor from antitrust law, based on these duopolists' own malfeasance.
- **Setting Bad Precedence:** Such action goes in the face of common sense, and sets a remarkably bad precedence for other existing and future FCC licensees. Approval in the case of this Sirius-XM merger would, in essence, encourage those licensees to break the rules and ignore the FCC, as well.
- **Core Reasons for Delay:** In conclusion, leading up to the proposed merger announced in February 2007, and even as of today, the inter-operable radio was never built simply 1) because doing so would risk give away business to a competitor; 2) because Sirius and XM were obligated to do so only on a voluntary basis (i.e., because the FCC never gave them a date certain by which they had to complete and distribute such an inter-operable radio to consumers); 3) because they both had more than a dozen things that were, at the same time, more important; and 4) because they could both make more money sticking to their own versions of hardware and software, which meant not only higher subscriber counts relative to the competition, but separate sales and profits for every unit sold (instead of having to share with the competition).

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[8] **Spending Priorities?** While in 10 years leading up to the merger announcement in February 2007, approximately $25 mil. was invested by both Sirius and XM developing inter-operable radios, $700 mil. was invested by one company on the services -- for five years -- of a single talk radio personality. Is this 1 to 28 disparity in spending an indication of the companies' intentions to take FCC mandates seriously in the future development and growth of their products and services? Is this 1 to 28 disparity in spending an indication of the companies' concerns for the best interests of their new (i.e., would-be) and current subscribers (and of consumers at large)? Or are we looking at something else?