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ON BEHALF OF

THE CONSUMER FEDERATION OF AMERICA,

CONSUMERS UNION,

AND

FREE PRESS

ON

COMPETITION AND THE FUTURE OF DIGITAL MUSIC

BEFORE THE
INTELLECTUAL PROPERTY TASK FORCE
OF THE
HOUSE JUDICIARY COMMITTEE

FEBRUARY 28, 2007

Consumers Union,[1] Consumer Federation of America,[2] and Free Press[3] appreciate the opportunity to testify on the proposed merger between XM Radio and Sirius. The merger has profound short- and long-term implications for consumers and for antitrust policy as a whole. If this merger is approved by the Federal Communications Commission and the Department of Justice, the Committee should bar DOJ's door because there will be little justification for denying any future merger to monopoly in the entire communications/media product space.

The proposed merger of the only two satellite subscription radio companies -- XM and Sirius Radio -- should raise a red flag for both antitrust officials and communications regulators whose job is to promote competition and consumer choice in the marketplace. Not only were XM and Sirius prohibited from merging as a condition of getting their licenses to use the public airwaves to deliver their services, the enormous growth of satellite subscription radio service at very substantial monthly charges and consumer equipment costs over just a few years demonstrates that this service is, in fact, a distinct product and could develop into a vibrant competitive market. CFA, CU and Free Press believe the companies who seek to merge so soon after they began competing and offering consumers innovative new services; so soon after they demonstrated that subscription radio is attractive to consumers and could be

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[1] Consumers Union is a nonprofit membership organization chartered in 1936 under the laws of the state of New York to Provide consumers with information, education and counsel about good, services, health and personal finance, and to initiate and cooperate with individual and group efforts to maintain and enhance the quality of life for consumers. Consumers Union's income is solely derived from the sale of *Consumer Report*s, its other publications and from noncommercial contributions, grants and fees. In addition to reports on Consumers Union's own product testing, *Consumer Reports* with more than 5 million paid circulation, regularly, carries articles on health, product safety, marketplace economics and legislative, judicial and regulatory actions which affect consumer welfare. Consumers Union's publications carry no advertising and receive no commercial support.

[2] The Consumer Federation of America is the nation's largest consumer advocacy group, composed of over 280 state and local affiliates representing consumer, senior, citizen, low-income, labor, farm, public power an cooperative organizations, with more than 50 million individual members.

[3] Free Press is a national, nonpartisan organization with over 350,000 members working to increase informed public participation in crucial media and communications policy debates.

much more so with consumer-friendly pricing; and in total disregard of the licensing conditions they accepted in order to use pubic resources carry an enormous burden to demonstrate why public officials should abandon all normal rules associated with competitive markets and spectrum licensing to allow this merger. CFA, CU, and Free Press have seen no evidence to support such a showing and therefore urge the DOJ and FCC to reject this merger unless and until XM and Sirius present clear-cut facts demonstrating how consumers will benefit from less satellite radio competition.

This merger raises the most fundamental issues in antitrust and poses a substantial threat to consumers and competition. In order to exercise their responsibility under the antitrust law, the federal agencies must start from the assumption that the XM-Sirius merger is a merger to monopoly — a merger between the only two firms in the market for national subscription radio service. The product and geographic market characteristics of satellite radio are easily identifiable and quite distinct from other mobile and stationary listening products. It is national, mobile, programmed radio entertainment. The two service deliver and require consumers to purchase huge bundles of well over 1000 channels. There are two, and only two, entities providing such a service. The alternatives the companies suggest are substitutes do not possess this set of characteristics and, therefore, cannot be said to compete directly with the service. Entry into this market is restricted by the need to have a license to broadcast at frequencies that enable the service to be provided nationwide. Consumer switching costs are substantial. The original licenses were issued under strict conditions that the two entities are not allowed to merge. There is no circumstance more concerning from the point of view of the antitrust laws and the 1996 amendments to the Communications Act than a merger within a distinct product market that takes the number of competitors from two to

one. Merger to monopoly is antithetical to the antitrust laws, perhaps the worst offense against the basic principle that competition is the consumer's best friend.

Having launched their investigation from this obvious and appropriate starting point, antitrust and Communications Act authorities will no doubt hear all sorts of excuses about why they should allow this monopoly to be created. Indeed, we have already heard them in the media from the army of public relations specialists and lobbyists that the merging firms have hired. But, in the post-Abramoff era, lobbying muscle and political influence can no longer be allowed to short circuit careful analysis of the market structure or trump clear threats to the public interest. The proponents of the merger should bear a very heavy burden in an objective and transparent review at both the Department of Justice and the Federal Communications Commission to justify such a clearly anticompetitive and anti-consumer merger.

We remain unconvinced by the excuses we have heard offered to justify the merger.

The claim that national subscription radio service competes, indirectly, with a variety of partial substitutes is suspect. The track record of intermodal competition disciplining anticompetitive abuse is poor at best. "Bank shot competition" – the claim that partial or poor substitutes that are fundamentally different than the target product – has failed to protect consumers in similar situations and the result of relying on such competition in both merger and regulatory reviews has been rising prices and stagnation.

A perfect example is cable television. In the 1980s, the FCC claimed that cable TV competed with over-the air broadcasting. Based on that understanding, the FCC chose to deregulate cable systems in communities with three or more broadcast signals. Cable rates subsequently skyrocketed. By the late 1980s the failure of this intermodal competition to

discipline cable pricing was so obvious that the FCC proposed to increase the number of over-the-air stations necessary to represent effective competition to six. Seeing the results of this failed policy, Congress re-regulated cable for a short period in the early 1990s. It also set conditions to help DBS satellite compete against cable (another form of intermodal competition).

In the decade after the Telecommunications Act of 1996, which largely deregulated cable rates, intermodal competition between cable and satellite failed to discipline cable rate increases. Average monthly cable bills have doubled since the 1996 Act. In short, intermodal competition from neither over-the-air TV nor from digital distribution disciplined cable rates. The former had more limited channel capacity; the later had greater channel capacity. It did not matter. The empirical evidence from the cable space is clear. Only head-to-head competition delivers relief from anti-consumer, anticompetitive pricing.

In the satellite radio service product space, we face a similar configuration of products. Traditional broadcast radio, digital Internet distribution and mobile handheld devices, like iPods, that allow consumers to store and play music from their own collections or from online music sites are touted as the intermodal competitors that will discipline prices. Yet there are distinct differences in product quality, listener experiences and mode of delivery. The touted competitors are not national, not mobile or not programmed. Experience and careful analysis suggests that the effort to position satellite radio as merely one product option in a broader product market should be rejected.

Consumers in the satellite radio space are afflicted by the very same pricing practices that afflict consumers in the cable space. Not only are prices high, but also the consumer is offered only large bundles of channels over which they have no choice. Consumer choice and

consumer sovereignty are denied. In a product market where the marginal production cost of adding subscribers is almost zero, the bundling strategy is irrational and anti-consumer.[4] The merger promises to make matters worse, with large capacity systems leading to larger consumer bundles. The merging parties have suggested they may provide consumers greater choice over the channels they pay for if the merger is approved. But they are not now prevented from doing so and it is unclear that even if the merger is approved the merging parties will offer true choice — that is channel-by-channel selection options for consumers.

The suggestion that free, over-the-air radio will discipline pricing abuses after the satellite radio firms merge to monopoly, even though it did not restrain their pricing practices when they faced head-to-head competition, is ludicrous on its face. Claims that existing or emerging distribution systems, like cell phone or Internet radio, will discipline the satellite radio monopolists pricing practices are equally suspect. The iPod has been around for a while, and phenomenally successful, but it sells a very different service and its existence did not discipline satellite radio pricing practices when there was head-to-head competition. There is no reason to believe that it will do a better job if a satellite radio monopoly is allowed to come into existence. Cell phone firms engage in equally anti-consumer, anti-competitive practices on their closed networks. The dominant national cell phone operators are also the dominant regional Internet Service Providers (AT&T and Verizon), and they have made it clear that they intend to extend the worst discriminatory practices from the cell phone and cable worlds to the broadband networks. Consumers can hope for little relief from this quarter.

[4] The marginal production costs are certainly very low, if not zero, but we are told that the marginal transaction costs (i.e. customer acquisition costs) are high. However, it appears that this problem is a function of the bundling strategy. Having set such a high threshold price, the companies are forced to market aggressively to much narrower market segment.

The claim that these are failing firms that have not yet found an equilibrium in a new market does not answer the fundamental public policy questions. And mismanagement should not be an excuse for monopoly.

Management has made some pretty obvious mistakes. They mortgaged their future in a bidding war for talent that has placed an unnecessarily heavy burden on the enterprise and then tried to recoup that mistake by high and rigid, big-bundle pricing. They have pursued this rigid, big-bundle high-price strategy in an industry where the marginal cost of adding subscribers is low (excluding so called customer acquisition and purported equipment-subsidy costs). Having driven costs through the roof on the supply-side and restricted demand with anti-consumer pricing on the demand-side, the companies now plead poverty and seek monopsony power over content providers and monopoly power over consumers in the national, mobile radio market.

Although the specific product is new, having been made possible by recent technological advancement, it has achieved a size that establishes it as a distinct product and makes it worthy of public policy attention. Annual revenues exceed $1 billion per year. Abuse of market power in this space could impose a substantial cost on consumers.

Perhaps the most outlandish of all the claims being circulated by the merging parties is the argument that consumers will be better off with a benevolent monopolist than competition. In this ultra-short term view, competition is defined as wasteful, since redundant facilities lie unutilized. The monopolist can serve everyone while using less resources and the monopolist promises not to abuse the market power that would result. Without the stick of competition, however, the cost savings simply will not be passed through to the consumer.

Indeed, the increase in market power will allow the post-merger monopoly to raise, rather than lower prices.

The promise of benevolent monopoly is not worth the paper it is written on. The merging parties suggest the merger will increase consumer choice by giving consumers more than the 130 to 170 channels now available to them by consolidating their offerings, omitting the duplicative offerings while retaining highly demanded and niche channels — these are options that consumers can only have to date by subscribing to both services and buying two radios. Yet there is little discussion that of the fact that it is the parties' own practices that have denied consumers choice in the past. Despite requirements by the FCC and the terms of their own patent dispute settlement to develop and provide interoperable radios that would have allowed consumers to switch providers without switching equipment, the companies have failed to meet that commitment. Now, we're told dual platform radios are on the cusp of development and will allow consumers to receive both signals simultaneously easing technological challenges of the merger. But technology that allows consumers to switch services or subscribe to both if they choose should have been available independent of a merger. Yet instead of promoting consumer choice, the merging parties have forced consumers to invest in equipment that works with just one service, and once so invested, are stuck with that choice.

The desire by telecommunications service providers to lock consumers into their service by developing equipment that works only with their service and engaging in exclusive manufacturing arrangements is not new. This is a dominant practice by both cell phone providers and cable providers. Here, greater enthusiasm by the merging parties for interoperable and dual platform radios prior to the merger would have facilitated the very

choice they now purport to offer consumers under the merger but *without* the necessity of a merger. It's important to point out that in their discussion of consumer choice, the merging parties fail to consider the loss of choice between the two providers as a meaningful one. The two parties have not, as a matter of business practice, offered consumers the most fundamental choice – which channels to pay for. They stuck to a high-priced, high volume bundle, which is anti-competitive and anti-consumer.

Moreover, under the scant details released to date, it remains unclear what additional equipment costs will be imposed on consumers as a result of the merger and whether, if consumers fail to invest in additional equipment, they will enjoy benefits the parties purport to provide to their subscribers.

Because this is a unique product market, once the competition is eliminated, prices will rise and no commitments have been made to the contrary. More importantly, the primary driver of innovation and progress in both programming and technology – competition in the market – will be eliminated. Innovation will slow to the pace preferred by the monopolist and consumers will be much worse off in the long run. This is a Faustian bargain that America rejected over a century ago when we affirmed our commitment to competition by enacting the Sherman Act. The short-term benefit of a monopolist who is subject to political oversight is simply not worth the long-term costs of abandoning the competitive engine of economic progress.

Offers of conditions on the mergers should also be taken with a grain of salt. The recent track record of conditions has been abysmal and the satellite radio industry has already proven that it cannot be trusted to live up to conditions imposed on it. Let us be clear. The licenses were issued subject to the condition that the licensees never merge. Yet here they are

asking to be excused from that condition. The licensees promised to offer the public interoperable radios that would work with on both networks. Yet, ten years have passed and there is no such interoperability. We are told interoperable radios have been developed but are too costly and thus manufacturers will not install them. Yet we have no ability to verify whether the lack of commercial availability of interoperable radios is due to cost, is the result of technical barriers, or instead is a strategic decision to impose barriers to prevent consumers from switching services. The parties have violated conditions about non-interference and use of terrestrial repeaters. In short, from day one they have failed to meet the conditions of their licenses and the public has suffered as a result.

This merger has such a high threshold to pass that at this stage of the merge review, we refuse to play the merger condition game. If the antitrust and regulatory authorities are diligent in the merger review process, they will turn up a host of competitive, pricing, bundling, contractual, and equipment issues and practices that counsel denial of the merger. If, in spite of that clear message, they choose to allow the merger, there will be time to craft meaningful conditions with strong, automatic enforcement mechanisms, so that the dismal record of recent merger conditions is not allowed to repeat itself.

A satellite radio merger to monopoly is about an avalanche of mergers. There was a key moment a decade ago when the Department of Justice decided that a large monopolist is no worse then two smaller monopolists and allowed the Bell Atlantic-NYNEX merger to go forward. That decision opened the door to a wave of mergers that doomed head-to-head competition in telecommunications. The old telephone monopoly was recreated as two huge geographically distinct monopolies that rarely if ever compete.

A satellite radio merger to monopoly will perform a similar bellwether function. If the agencies with oversight adopt a loose definition of products and markets and allow a merger to monopoly on the basis of intermodal competition, then a tsunami of mergers will ripple through the digital space at the worst possible moment. The firms that have declared their undying hostility to the open flow of products in the digital economy (broadcasters, telephone/cellular companies, cable companies), will be empowered to capture and stifle the alternatives, under the premise that every media and telecommunications product competes with all others and that new technologies and services will come along to protect the consumer in any case. That relief, however, will be slow and insufficient because the competitive core of the digital economy will have been damaged and the critical terrain of the digital economy will be controlled by entities who have the same anticompetitive anti-consumer objectives as the merging parties in this case.