

CLIENT ADVISORY

DEPARTMENT OF JUSTICE CLEARANCE OF SATELLITE RADIO MERGER: HAS DOJ CHANGED ITS APPROACH TO HORIZONTAL MERGERS?

On March 24, 2008, after an investigation that lasted more than a year, the Department of Justice Antitrust Division announced its decision to close its investigation of the proposed merger of XM Satellite Radio Holdings Inc. ("XM") with Sirius Satellite Radio Inc. ("Sirius").¹ Consistent with its recent and salutary policy of explaining its decisions to close certain investigations, the Department issued a statement that set forth its reasoning. Unfortunately, the Department's explanation raises as many questions as it answers. While, at first blush, some of the Department's explanation seems to suggest greater openness to arguments that have generally been rejected by the antitrust agencies in the past, there is reason to think that the explanation is based on the unique facts of this case, and the Department's analysis is elastic enough that it can be applied with different results in other situations.

I. WOULD XM AND SIRIUS COMPETE IN THE FUTURE?

The Department properly took a forward-looking approach and assessed the extent of likely future competition between the two satellite radio providers. It concluded that future competition would be limited. The Department noted that competition for consumers who already have subscribed to a satellite radio service is limited due to the lack of interoperability between the radios and networks of the two services, and the resultant lock-in.² Of course, equipment lock-in is not limited to satellite radio. For example, in the EchoStar-Hughes merger, the Department found head-to-head competition despite the fact that a subscriber to one satellite TV service would have to replace her satellite dish and receiver in order to switch to a competing service. Firms competing in such industries have found ways, including equipment subsidies, to overcome barriers to switching. The antitrust agencies have rarely concluded that horizontal competition does not exist because of such lock-in.

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¹ Press Release, US Department of Justice Antitrust Division, Statement Of The Department Of Justice Antitrust Division On Its Decision To Close Its Investigation Of XM Satellite Radio Holdings Inc.'s Merger With Sirius Satellite Radio Inc. (March 24, 2008), available at http://www.usdoj.gov/atr/public/press_releases/2008/231467.htm.

² The satellite radio licensees were obligated by the FCC to develop interoperable radios, but this has not yet occurred.

The Department also found that future competition between Sirius and XM would be limited because (1) the auto manufacturers have become an increasingly important distribution channel for attracting new subscribers and (2) Sirius and XM have entered into exclusive contracts with all the major car manufacturers that run to 2012 or beyond. There is logic to this point; if all the customers have been won for the long term there would be no meaningful future competition.³ In other situations, however, the antitrust agencies have not stopped looking at a merger because of the phenomenon of long-term contracting, but rather have focused on the competition that would occur when the contracts expire.

In this case, it may be that the auto manufacturers were supportive or, at least, not opposed to the merger, which would make it harder for the Department to bring a case based on anticompetitive effects in this important distribution channel. As discussed below, the Department also found that there might be other alternatives to XM and Sirius by the time these contracts expire.

The Department did not include any specifics regarding what percentage of original sales occur in the car distribution channel versus distribution in retail stores. The Department did find that future competition in the retail channel would continue to be important, even though sales through this channel are declining relative to the car manufacturer channel. However, as discussed below, the Department disposed of this concern through an expansive approach to product market definition.

II. WHAT ELSE COMPETES WITH SATELLITE RADIO?

Looking at the retail channel, the Department determined that the relevant product market could not be limited to the products of the two satellite radio firms. Further, the Department found that evidence did not support the conclusion that the merged firm could profitably raise the price of satellite radio service.

³ Cf. *U.S. v. Gen. Dynamics Corp.*, 415 U.S. 486, 501-02 (1974) (a coal producer's historic market share is irrelevant if it no longer has any uncommitted reserves to sell).

With regard to the proper product market in which to assess the proposed merger, the Department made a brief, conclusory statement that other audio entertainment alternatives, including “traditional AM/FM radio, HD Radio, MP3 players (e.g., iPods®), and audio offerings delivered through wireless telephones...used individually or in combination, offer many consumers attributes of satellite radio service that they may find attractive.”⁴ However, the Department did not discuss how or why these purported alternatives actually could or did constrain the pricing of satellite radio, or whether a small increase in monthly subscription fees for satellite radio—\$0.65-1.30, using the standard five or ten percent increase as a guideline—would cause a sufficient number of consumers to abandon satellite radio and instead choose from among these other audio entertainment alternatives to make the price increase unprofitable. The Department also did not discuss why the differentiated features and content of the various purported alternatives did not argue for a more narrow product market. It may be that the economic analysis done by the Department supports a broader product market in this case, but this seems to conflict with the Department's approach in most other cases, where it has tended to define product markets much more narrowly.

The Department also concluded that a post-merger price increase was unlikely because the offerings of Sirius and XM are differentiated with regard to content offerings. For instance, a consumer may choose Sirius in order to listen to Howard Stern, while XM may attract customers through its Major League Baseball offering. However, similar product differentiation occurs in many other markets, and a modest degree of difference is rarely enough to define completely separate markets. The Department has challenged mergers in the radio industry where the merging firms operate

⁴ Press Release, US Department of Justice Antitrust Division, Statement Of The Department Of Justice Antitrust Division On Its Decision To Close Its Investigation Of XM Satellite Radio Holdings Inc.'s Merger With Sirius Satellite Radio Inc. (March 24, 2008), available at http://www.usdoj.gov/atr/public/press_releases/2008/231467.htm.

stations offering completely different programming formats, a far greater degree of differentiation than that between Sirius and XM. Unless it is rare that the merging firms compete for the same customers, the antitrust agencies have generally considered firms offering similar products to be in the same market. While XM and Sirius have tried to differentiate themselves through expensive competition for attractive exclusive content, in the main both offer a similar menu of diverse programming. We do not know, however, whether the data reviewed by the Department led to the conclusion that the customer bases of the two carriers were in fact quite distinct.

Moreover, there seems to be some tension between the Department's reasoning that the product market is broad and includes "traditional AM/FM radio, HD Radio, MP3 players (e.g., iPods®), and audio offerings delivered through wireless telephones" on the one hand, and the Department's contention that XM and Sirius may not even be very good substitutes for each other because of their different content offerings on the other hand.⁵ These positions are not, however, impossible to reconcile. The Department could have concluded that, today, XM and Sirius do not meaningfully compete, but (a) to the extent they do, each faces other alternatives and (b) those alternatives will be increasingly important in the future. It is probably true that the big struggle for XM and Sirius is to persuade consumers to pay \$13 or so a month to receive audio entertainment when there are so many other ways, including free over-the-air radio, to get what may be similar content. But the Department's statement does not provide great clarity as to how it resolved this issue.

III. WHAT'S NEXT: THE IMPORTANCE OF ANTICIPATED INNOVATION?

The Department also stated that "any inference of competitive concern was further limited by" the likely introduction of new technology platforms in the near future that would provide further competition for satellite radio. The "[m]ost notable" such technology is "the expected introduction within several

years of next-generation wireless networks capable of streaming Internet radio to mobile devices." The fact that consumers "are likely to have access to new alternatives, including mobile broadband Internet devices, by the time the current long-term contracts between the parties and car manufacturers expire," was cited as another reason why the merger will not threaten competition.⁶ It is unclear how likely and how soon the emergence of new technology must be in order to be considered a mitigating factor with regard to possible anticompetitive effects resulting from a proposed merger. Indeed, the antitrust agencies generally discount the impact of emerging new technologies as offsetting a current reduction in competition, especially when those technologies have not yet been established in the marketplace. It is possible that the Department would have made a different finding if the contracts with auto manufacturers in this case expired sooner.

IV. HOW WILL THE MERGER BENEFIT CONSUMERS?

The Department validated the parties' claims that the merger would produce "significant variable and fixed cost savings" that would likely be passed on to consumers in the form of lower prices. In particular, it found the merger would likely allow the parties to "consolidate development, production and distribution efforts on a single line of radios, which would eliminate duplicative costs and realize economies of scale."⁷ Once again, the same argument might be made in many other cases that involve the manufacture and distribution of products, although the magnitude of the gains might be different. Here, given the relatively small sales of satellite radios, it is likely that the parties are far short of achieving economies of scale, and the merger may help substantially in driving costs down.⁸

It is important to note, however, that the Merger Guidelines state that "[e]fficiencies almost never justify a merger

⁵ *Id.*

⁶ *Id.*

⁷ *Id.*

⁸ Of course, it is not clear how much of these cost savings would be realized directly by the merging parties and how much would flow to their equipment suppliers, but the savings may be real nonetheless.

to monopoly or near-monopoly.”⁹ Thus, the finding that the market is broader than satellite radio is crucial to the importance the Department attributes to the parties’ efficiency claims, as well as its ultimate decision not to challenge the merger.

V. IS MERGER TO MONOPOLY NOW PERMISSIBLE?

The Department provided defensible reasons for not challenging the merger, but every argument put forth in the Department’s statement echoes arguments it has often rejected in the past. Given this fact, one is left to wonder why the Department adopted these arguments in this case.

One possibility is that the Department did a thorough empirical analysis and found that the evidence would not support a contention that prices would go up as a result of the merger. In other words, the Department found that it did not have a case it could win in court, and given the antitrust agencies’ recent track record in court caution may be warranted. But one is tempted to ask whether there is any case the Department can win if it could not prove that Sirius/XM could get away with a price increase of \$1.30 or less once it becomes the sole satellite radio firm.

A second, and more likely possibility, is that the Department concluded that the two satellite radio firms, which have never made a profit and have had significant losses, have been involved in a death struggle. There may be room for only player in a business that has yet to establish itself with the public and that may never get there, especially in light of the emergence of new technologies and new ways of obtaining audio entertainment. This fact, coupled with a lack of strong opposition to the merger—consumer groups were divided and the most persistent opponent, the radio broadcasters, are unsympathetic—may have led the Department to reason its way to clearing the deal in the hope that it will create at least one player with a chance at surviving.

There are arguments in the Department’s statement that can, and surely will, be used by merging parties in future

cases. The emphasis on product differentiation; lock-in (due to lack of interoperability and long-term contracts); diverse and, in some cases, still far-off alternatives to the products of the merging parties; and efficiencies that seem to derive from the monopoly character of the merger, are all arguments that have not always fared well with the antitrust agencies. The seeming openness to such arguments is cause for some optimism in the defense of future horizontal mergers. However, given the necessarily fact-specific nature of the inquiry, and the unique facts presented here, any such optimism should be tempered. Sirius/XM is more likely an aberration than a new, more lenient approach to merger analysis.

The FCC is still considering the merger. From the statements of Chairman Martin and the parties, it appears most likely that there will be negotiated conditions providing for quasi-a la carte (actually, tiered) pricing—essentially assuring that consumers who don’t want to listen to Howard Stern don’t have to pay for him. Given the Department’s carefully articulated statements on competitive effects, it is unlikely that the FCC will come out differently on this issue or seek to block the merger.

We hope you find this summary helpful. If you would like more information about the DOJ’s analysis of the XM-Sirius transaction, please feel free to contact your Arnold & Porter attorney or

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⁹ US Department of Justice and Federal Trade Commission, *Horizontal Merger Guidelines*, Section 4 (April 8, 1997).