The proposed $11.4 billion merger of struggling satellite-radio operators XM Satellite Radio Holdings Inc. and Sirius Satellite Radio Inc. sets up a crucial test for the nation's regulators: how to weigh the limits of consolidation against rapid changes in media technology.

The deal is structured as a 50-50 "merger of equals," giving XM and Sirius shareholders an equal stake in the combined company, and potentially uniting a roster of talent that includes Sirius's shock jock Howard Stern and daytime-TV personality Oprah Winfrey, one of XM's biggest stars. The agreement calls for Sirius Chief Executive Mel Karmazin to serve as CEO of the new entity, which would have more than $2.3 billion in long-term debt. XM Chairman Gary Parsons would be chairman.

But because XM and Sirius are the only two companies licensed by the Federal Communications Commission to offer satellite radio in the U.S., the deal is likely to face significant regulatory obstacles.

Broadcasters said yesterday that they will fight the proposed merger, and FCC Chairman Kevin Martin released an unusually grim statement saying that the two companies will face a "high" hurdle, since the FCC still has a 1997 rule on its books specifically forbidding such a deal which would need to be tossed. The transaction also requires the Justice Department's blessing.

Indeed, XM and Sirius may be rushing into a deal because they sense the regulatory terrain will only get tougher. People close to the matter said that the two companies acted because the climate is already changing with the election of a Democratic-controlled Congress. Future developments -- such as the possibility of a Democratic president -- could make it even harder for the proposed merger to pass muster.

In their strategy, the two companies may be subtly acknowledging the risks before them: By conceiving their deal as a merger of equals and declining to say which company name would emerge ascendant, they minimize the business risks should the deal fall through. If, for example, the combined company were to be dubbed Sirius, XM could be vulnerable to a decline in sales during a regulatory review period that could last a year. A person familiar with the negotiations said the two companies have set March 1, 2008, as their "drop-dead date," after which either side can walk away if approval is not granted.

The coming regulatory battle is likely to focus on the definition of satellite radio's market. The two companies are expected to argue that the rules established a decade ago, which
require two satellite rivals to ensure competition, simply don't apply in today's entertainment landscape.

Since 1997, a host of new listening options have emerged, making the issue of choice in satellite radio less important for consumers. Executives cite a new digital technology called HD radio, iPod digital music players, Internet radio and music over mobile phones as competitors that didn't exist when the satellite licenses were first awarded.

Just a few years ago, the two satellite rivals were the hot new technology on the media scene, offering consumers greater choice in both music and talk programming in exchange for a monthly subscription fee. But while both companies have continued to add subscribers steadily, their growth has slowed, in part because of the other new devices and services competing for the same potential listeners.

Both XM and Sirius have continued to lose money. In 2005, the companies had combined losses of $1.5 billion, after losing a combined $1.4 billion the year before. Their 2006 results haven't been released, but Goldman Sachs analyst Mark Wienkes estimates that Sirius lost $1.1 billion on revenue of $628.8 million last year, while XM lost $658.2 million on revenue of $914 million.

Consumers and their advocates are likely to worry that a combined company would mean higher prices for satellite-radio service. Both companies now charge $12.95 a month.

But company executives say market forces would limit the possibility of higher prices. "We are competing with companies that give away their product for free," said Mr. Karmazin, alluding to conventional over-the-air radio.

Satellite-radio customers will still be able to use their existing satellite radios for the foreseeable future, but to take advantage of a combined service, they probably would need to upgrade to a newer radio. Currently, Sirius and XM run on separate, incompatible systems, although a team of engineers from both companies has been working on a radio that could pull in both signals.

"The benefits to the subscribers are awesome," Sirius's Mr. Karmazin said in an interview. "We can combine [research and development] resources and come up with cooler, more advanced products that will satisfy them more. We're going to have the ability to negotiate better with our receiver manufacturers."
The companies could also eliminate duplicative services. For example, XM features a Christian-music-themed channel called "The Message," while Sirius has its own Christian pop channel dubbed "Spirit." By Mr. Karmazin's reckoning, the two companies could eliminate such overlap and concentrate on unique shows and new technology to deliver it. "There's going to be more consumer choice," Mr. Karmazin said.

It remains to be seen whether the FCC shares that view. In his statement yesterday evening, Mr. Martin said the FCC would certainly review the deal, but "the companies would need to demonstrate that consumers would clearly be better off -- with both more choice and affordable prices."

A larger problem for the companies, however, is opposition from broadcasters, to whom Mr. Martin has been an ally in the past. Two years ago, the National Association of Broadcasters lobbied hard against XM's effort to acquire WCS Wireless LLC for $195 million. The deal would have given XM additional radio frequencies and allowed it to expand its service.

Broadcasters, however, complained that XM would use the acquisition to provide local programming, which isn't allowed under its current license. Ultimately, the deal fell through after languishing without action at the FCC for nearly a year.

The broadcasters quickly went on the offensive yesterday. "When the FCC authorized satellite radio, it specifically found that the public would be served best by two competitive nationwide systems," said NAB spokesman Dennis Wharton. "Now, with their stock prices at rock bottom and their business model in disarray because of profligate spending practices, they seek a government bailout to avoid competing in the marketplace."

The FCC's five commissioners will need to be convinced that there's enough competition in the market to support a merger. One issue the agency will likely consider, FCC officials say, is satellite radio's popularity with consumers and the two companies' long-term prospects if they don't merge.

With the FCC currently immersed in what's likely to be a protracted fight over changes to media-ownership limits, it may not be an auspicious time to propose a deal to consolidate the satellite-radio industry.

Democrats at the FCC have been more assertive since their party took control of Congress. And some lawmakers have already begun to express doubts about the deal.

Massachusetts Democrat Edward Markey, chairman of the House subcommittee that oversees the FCC, said yesterday that he will review the proposed merger's effect on consumers. "In light of the dramatic consolidation of radio ownership...I believe that the merger of the only two satellite radio companies must be assessed with an eye toward ensuring that it does not have a similar, deleterious effect on diversity on the dial and localism in radio coverage and reporting," he said in a statement.
Under the deal, XM shareholders will receive a fixed exchange of 4.6 shares of Sirius for each of their XM shares. Based on stock prices Friday, that meant that XM holders would receive $17.02 for each of their shares, a premium to Friday's close of $13.98. XM Chairman Parsons had argued for more, people familiar with the matter said, based on his company's more-extensive deals with auto makers and its 7.6 million subscribers, compared with Sirius's six million. But Mr. Karmazin stuck to his guns, stressing Sirius's bigger market capitalization and faster growth rate.

The market was already responding to the possibility of a deal on Friday, bidding XM stock up by nearly 8%. In agreeing to a premium for XM, Sirius is getting a larger ownership stake than if it had simply contributed its business into a new company.

So-called "mergers of equals" have had a dubious track record, according to a number of academic studies of big corporate transactions. That's largely because under such plans, companies can end up bickering over managerial control and strategy, which can be distracting and ultimately costly to shareholders.

Sirius and XM executives played down that prospect. "Synergies have become such a very large element of value compared to the individual values of the companies," said Mr. Parsons, though he conceded that the two sides debated for months about who should own the biggest part of the company. "That drove us to look at it together."

Sirius has performed better in recent quarters at retail, winning large numbers of customers who walk into a store to buy a satellite radio to add to their car. But XM has positioned itself better for the future, signing up more deals with auto makers such as General Motors Corp., so cars roll off factory lines with satellite radios preinstalled.

Expensive programming one-upmanship has weighed on the stock prices at both companies. For example, in 2004, Sirius said it would pay $500 million over five years, not including performance-based bonuses, to broadcast a morning show starring the colorful Mr. Stern. Two weeks later, XM said it would pay $650 million over 11 years to broadcast Major League Baseball.

"The strategic benefits of a merger would be tremendous," said Craig Moffett, an analyst at Sanford C. Bernstein. "Programming contract renewals would no longer be the subject of bidding wars. Automotive revenue-sharing agreements and retailer commission deals would suddenly be uncontested."

Sirius was advised on the deal by Morgan Stanley and law firms Simpson Thacher & Bartlett LLP and Wiley Rein LLP. XM was advised by J.P. Morgan Chase & Co. and law firms Skadden Arps, Slate, Meagher & Flom; Jones Day; and Latham & Watkins.
Questions:

1.) What are the functions of the ‘Federal Communications Commission’?

2.) What are the regulatory obstacles the merger between Sirius and XM is facing?

3.) Discuss the market structure of the Satellite Radio market?

4.) How would you evaluate the economic consequences of the merger deal between Sirius and XM?