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## EchoStar/DirecTV: Pitfalls on the Road to DBS Consolidation

Some have heralded the October 2001 agreement to merge EchoStar and Hughes Electronics as the culmination of the eighteen-month contest pitting Charlie Ergen against Rupert Murdoch for the prize of acquiring DirecTV and its 10 million DBS subscribers. In fact, however, the EchoStar-Hughes merger is just the latest chapter in a saga involving these and other players that goes back at least a decade. And the final chapter in this long-running story has yet to be written.

As in any major business combination, the proposed merger will not be a *fait accompli* until all necessary government approvals have been obtained - principally antitrust review by the Justice Department ("DOJ") and approval of the transfer of the satellite licenses by the Federal Communications Commission ("FCC"). Some analysts have been so bold as to predict that there is little or no chance that regulators will approve the deal due to competition concerns. While this assessment is unduly harsh in the present deregulatory environment, there are many pitfalls that could derail the agreement - perhaps through the imposition of conditions too onerous for the parties to accept rather than through outright rejection.

### **The National Consumer Video Distribution Market**

One key determinant in the merger's chances of approval will be how DOJ defines the product market in which EchoStar and DirecTV compete. EchoStar CEO Charlie Ergen has been quoted as declaring that, if the relevant product market is defined as satellite television rather than the larger multichannel video programming distribution ("MVPD") market - including cable, DBS, wireless cable, C-band direct-to-home service, open video systems and, prospectively, Internet broadband - then even he would not approve the transfer. Ergen's declaration clearly reflects, with characteristic brio, a substantial amount of confidence that the DOJ will see things his way.

Mr. Ergen's confidence is likely well-founded in this regard, especially considering that DOJ has previously argued affirmatively before the FCC - during the Clinton Administration, no less - that DBS and cable

are largely substitutable services, and are therefore part of the same product market. Coincidentally, the DOJ opinion was expressed in the context of EchoStar's acquisition of 28 DBS channels at the 110° W.L. orbital location from MCI, which intended to pursue a venture with Murdoch's News Corp. to provide satellite video service under the ASkyB brand. The ASkyB venture failed to materialize due to the changing nature of the MVPD market and the need for increased capacity to compete with digital cable and Internet broadband services - the very same market forces that are driving the much larger deal now before DOJ and the FCC. At least for the moment, it is Murdoch who is again out in the cold.

Viewing the EchoStar-Hughes transaction as part of the larger MVPD market will clearly be a boost for the deal in that the combined DBS entities would have only about 17 million subscribers out of the more than 85 million that make up the entire MVPD marketplace. Indeed, if approved, the AT&T-Comcast cable combination would encompass approximately 21 million subscribers, not quite one-quarter of the marketplace. AOL Time Warner, already established as the third major entity in the marketplace, presently has about 13 million subscribers. Thus, viewed in the context of the national MVPD market, the combination of EchoStar and DirecTV can be seen as simply an effort within the DBS sector of the market to keep pace with the ongoing consolidation in the cable sector.

### **Local Market Concentration**

Passing the national product market hurdle, however, is just the beginning of the larger competition analysis, in that regulators also look carefully at specific geographic markets. In the case of the MVPD business, after all, each consumer does not have the ability to access the network of every cable company in the country, but can only choose to subscribe through an operator that has a physical network in his or her area - typically this number is one. In many rural areas, however, the number of cable systems is zero, so that elimination of DBS competition would reduce the total number of service providers to just one.

There is some disagreement as to whether or not this reduction in actual head-to-head competition would impact a significant number of consumers. Estimates of the number of households whose choices are currently limited solely to DBS companies range from a high of 19% to a low of around 3% - but cable penetration may actually be declining as low-capacity systems in areas where it is uneconomical to upgrade become obsolete. If the low end of the scale is correct, it may be appropriate to conclude that competition in 97% of the marketplace would protect the remaining 3% of consumers; although specific pricing concessions by the combined entity could be imposed to ensure that rural customers are protected from disparate pricing. Even that step, however, would not address concerns regarding the quality of customer service in a monopoly market - an area where a regulatory solution would be much harder to craft and enforce.

Moreover, the antitrust laws do not stop at constraining monopolies. Any business combination that could result in market concentration that is adverse to consumers will be scrutinized. Accordingly, the most



troublesome aspect of the EchoStar-Hughes merger may be the larger portion of the country where a single DBS operator and a single cable operator would share an MVPD service *duopoly*. Earlier this year, a federal appeals court overruled a lower court and enjoined a planned merger between the second and third largest baby food producers in the country (Heinz and Beechnut) based on the fact that the combination would create a near duopoly throughout the country between the combined company and the market dominant Gerber brand. This action derailed the merger, despite the fact that the combined national market share of Heinz and Beechnut would have been only about 30%.

### **Orbit/Spectrum Resource Considerations**

Duopolies may not always be viewed as "harmful to competition," but in the MVPD context, where the barriers to new entry are especially daunting, the prospects of such a finding are significantly enhanced. The combination of the DISH Network and DirecTV not only would place *all existing satellite TV subscribers* under the control of a single company, but more significantly, would place in the surviving corporation's hands the authorizations for *all of the DBS channels presently available for full-CONUS service*, and virtually all of the available spectrum that is currently assigned for any type of DBS service. Thus, the transaction would effectively limit to one the number of possible U.S.-based DBS providers, at least for the foreseeable future.

Although the FCC permitted EchoStar to control a total of 50 of the 96 CONUS DBS channels (a majority of the spectrum at each of the 110° W.L. and 119° W.L. orbital location) when it acquired the MCI DBS assets in 1999, it is still a long leap from that decision to a determination that control of all DBS CONUS spectrum by one entity is appropriate. In 1999, the FCC concluded that "the potential competitive benefits of allowing EchoStar to become a stronger competitor in MVPD markets . . . [outweighed] the potential competitive costs of *reduced* entry into the DBS industry" (emphasis added). It specifically found that a reduction in DBS competition was "mitigated by other entry possibilities" for "alternative transmission media." As noted above, while DOJ supported that transaction, it might not be so sanguine at this stage, with only limited near-term competition to cable emerging and the deal before it poised to eliminate, rather than reduce, competition in the DBS sector.

In the context of carrier services, regulators have historically sought to promote both intramodal competition and intermodal competition, i.e., fostering competition among different satellite providers as well as between satellite providers and terrestrial cable facilities. Accordingly, approval of the EchoStar-Hughes combination could come with significant divestiture conditions that would limit the spectrum aggregation efficiencies sought by EchoStar, and perhaps derail the DBS portion of the deal entirely.

### **The Bottom Line**

The many regulatory uncertainties outlined above leave it unclear who will be the ultimate victor, or victors, in



the long-running DBS saga. The legal issues presented, coupled with the deregulatory preferences of the Bush Administration, could result in some interesting behind-the-scenes debates between career staff at both DOJ and the FCC and the current high-level political appointees at these agencies. Mr. Ergen may win either by gaining approval of the deal without unduly draconian conditions, or by walking away from the deal after keeping the prize out of News Corp.'s hands long enough to gain market share at DirecTV's expense. In the latter scenario, Mr. Murdoch could still be a winner too, by securing an eventual foothold in the U.S. DBS market - perhaps at a lower price than would otherwise have been likely. Stay tuned.

*A slightly different version of the above article, authored by David Keir, a member of Lerman Senter PLLC, originally appeared in the February/March 2002 issue of "The Orbiter," the newsletter of the Society of Satellite Professionals International. Lerman Senter represented MCI in connection with its sale of DBS assets to EchoStar in 1999.*