

Before the
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Washington, D.C.

In the Matter of)	
)	
Adjustment of Rates and Terms for)	Docket No. 2006-1 CRB DSTRA
Preexisting Subscription and Satellite)	
Digital Audio Radio Services)	

WRITTEN REBUTTAL TESTIMONY OF DAVID J. FREAR

Introduction and Witness Background

1. I am an Executive Vice President and the Chief Financial Officer of Sirius Satellite Radio Inc. (“Sirius”). I submit this statement in support of Sirius’ written rebuttal case, in order to respond to various testimony presented by SoundExchange.

Updated Capital Expenditure and Operating Cost Information

2. In my October 30, 2006 Written Direct Testimony (“WDT”), I presented certain information regarding Sirius’ capital expenditures and operating costs. See ¶¶ 8-25. Most of this information was current through the second quarter of 2006, which was the most current public information that was then available. These issues were also addressed in the written direct testimony of SoundExchange witness Sean Butson. See Butson WDT at 15-23.

3. In my testimony at trial on June 11 and June 12, 2007, I presented certain updated information. See June 11, 2007 Transcript (Tr.) at 357-62; June 12, 2007 Tr. at 8. This information was updated through the end of the first quarter 2007. Much of this information appears in Sirius’ March 1, 2007 Form 10-K (for the year ending December 31, 2006) (“the 2006 10-K”), and May 10, 2007 Form 10-Q (for quarter ending March 31, 2007) (“the 1Q 2007 10-

Q”). A copy of the 2006 10-K is attached as SIR Exhibit 47 to this Written Rebuttal Testimony and a copy of the 1Q 2007 10-Q is attached as SIR Exhibit 57 to this Written Rebuttal Testimony.

Subscriber Projections

4. I have reviewed the projections submitted by Sean Butson in connection with SoundExchange’s written direct case. Based on my knowledge of Sirius’ business and its financial planning, I find these projections to be vastly overoptimistic and unrealistic, particularly in light of more recent developments and trends.

5. In his October 30, 2006 Written Direct Testimony, Mr. Butson projected that Sirius would end 2006 with 6,326,307 subscribers. See Butson WDT, App. A, at 3 l. 5. In fact, Sirius ended 2006 with only 6,024,555 subscribers, a difference of over 300,000 in a period of about two months after the projection was rendered. As I discussed in my testimony at trial (see, e.g., June 11, 2006 Tr. at 380, June 12, 2007 Tr. at 107-08), it was during this time period that we observed a significant slowdown in the retail channel, and in December 2006, Sirius itself was required to lower its 2006 year-end subscriber guidance from 6.3 million to 6.0 million. This change in the guidance highlights the difficulty of projecting subscriber growth even over a relatively short period, let alone over a number of years.

6. Mr. Butson also projected that Sirius would end 2007 with 9,373,572 subscribers. See Butson WDT, App. A, at 3 l. 5. I understand that Mr. Butson conceded at trial that this projection was unrealistic; I concur with that assessment. In fact, Sirius’ current guidance for year-end subscribers for 2007 is “over 8 million.” Thus, even for the current year, the difference between Sirius’ guidance and Mr. Butson’s projection is on the order of 1,300,000 subscribers.

Needless to say, the absence of these projected subscribers will have a material negative effect on Sirius' revenue, cash flow, and EBITDA, among other metrics.¹

7. Sirius does not currently provide longer term guidance with respect to subscriber growth, primarily because such projections are inherently uncertain, particularly for companies like Sirius that are in the early stages of their commercial launch. In fact, earlier this year we suspended our previous long term revenue guidance. While we have some models (usually in the form of Excel spreadsheets) that go out for longer periods, senior management and I generally do not focus on these later years, which are inherently speculative and less relevant for our immediate business decisions, nor do we as a management team make judgments about what particular assumptions should be used (as we do, for example, with respect to our guidance for the current fiscal year). Rather, to the extent that subscriber estimates for later years are considered, we often consider the consensus view of the various analysts who cover the company. My group regularly follows the reports of these analysts.

8. As I testified during the trial of the direct phase of this case, we became aware during the last quarter of 2006 and the first two quarters of 2007 of a significant slowdown in the demand for satellite radio, particularly on the retail side. Among other effects, and as previously discussed, this caused us to lower our 2006 year-end subscriber guidance. In addition, reflecting both the lower starting point and what appears to be softening demand, our 2007 year-end

¹ For illustrative purposes, using the \$10.46 monthly total average revenue per user ("total ARPU") disclosed in the 2007 1Q 10-Q (at 25), the loss of one million subscribers over the course of a full year would result in a decrease in revenue in excess of \$125,000,000 ($\$10.46 * 12 * 1,000,000$). While this reduction would not fully occur in the first year (because, as Mr. Butson correctly notes, subscribers join over the course of the year, rather than all at once), it would be felt every subsequent year until the subscriber deficit was made up, if that ever occurred. As discussed below, this appears highly unlikely given the unrealistic subscriber projections by Mr. Butson for each year of the upcoming license term.

subscriber guidance initially provided in late February 2007 was significantly lower than it would have been otherwise. At this time, we are not providing any guidance as to revenue or subscriber growth beyond 2007. Further, since we initially provided our 2007 year-end subscriber guidance, we have not seen any sign of a reversal of softening demand on the retail side.

9. We do not have any operative internal projections for subscriber growth for later years at this time. In view of the retail slowdown discussed above, the models that were prepared in the ordinary course of business and produced to SoundExchange in connection with the discovery in this case are now too optimistic to be relied upon. Moreover, since last fall, analysts covering the industry have noted the slowdown in subscriber growth and have adjusted their subscriber growth estimates accordingly.

10. Using data supplied by our vendor, InSync Analytics, my staff has prepared, under my supervision, a statement showing the consensus of satellite radio analysts with respect to projected gross subscriber additions (“gross adds”).² For every year in the upcoming license term, there is an enormous discrepancy between the current analysts’ consensus and Mr. Butson’s projections of gross adds.³ These differences are reflected in the table below (all numbers in thousands):

² “Gross adds” are incoming subscribers, which may be reported by channel (OEM or retail) or cumulatively. “Net adds” reflect the deduction of subscribers who are lost or “churned” during the same time period.

³ Certain analysts do not project out as far as 2012; thus, the data points are more limited in the later years.

Projected Sirius Gross Adds

	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>Cumulative</u>
Butson	4,857	5,570	6,102	6,478	6,856	7,230	37,093
Consensus	<u>4,076</u>	<u>4,415</u>	<u>4,935</u>	<u>5,415</u>	<u>5,799</u>	<u>6,093</u>	<u>30,733</u>
Difference	781	1,155	1,167	1,063	1,057	1,137	6,360

Over the six-year license term, the analysts' consensus reflects more than 6 million fewer gross adds than projected by Mr. Butson.

11. While the projections of gross adds in the analysts' consensus are themselves uncertain, and may also prove to be overly optimistic, as projections concerning this industry often have been, we are not aware of, nor do we have internally, any subscriber gross adds projections that we believe to be more reliable than the foregoing analysts' consensus. The analysts' consensus is much more realistic than the Butson projections relied upon by both Dr. Pelcovits and Dr. Ordover and is the considered opinion of analysts who actively follow satellite radio and regularly publish their views.

12. In order to provide a fuller picture of Sirius' financial outlook, we have used the consensus gross adds projections referenced above to create the income statement attached as SIR Exhibit 58. This is based principally on our standard internal model, as previously produced to SoundExchange, extended out to 2012. Using the analysts' consensus for gross adds, and our internal model for loss of subscribers or "churn," the following differences are apparent for end-of-year subscribers (in thousands):

Projected Sirius End-of-Year Subscribers

	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>
Butson	9,374	12,204	14,675	16,724	18,467	19,954
Model	[[
Difference]]

Mr. Butson's year-end subscriber projections exceed the more realistic figures in the model by an average of nearly [[]] million subscribers per year, every year during the license term.

13. The subscriber figures discussed above are used by the model to project subscriber and activation revenue for each year. With respect to revenue, SIR Exhibit 58 differs from the prior iterations of the model provided to SoundExchange in discovery in that it does not include the price increase that was planned for 2007, but ultimately rejected by management based on market conditions and the difficulty of competing against free radio. Thus, consistent with our current expectations, there is less revenue per subscriber than previously planned. In addition, we have adjusted the anticipated advertising revenue to be consistent with the analysts' consensus and more in line with the actual results that are being achieved.⁴ Finally, particularly in later years, we have been required to make various admittedly uncertain assumptions as to costs that might ensue (e.g., for contract renewals).

14. For all of these reasons, and particularly in the later years of the term, SIR Exhibit 58 must be considered somewhat speculative, as any long-term projection in this industry necessarily would be. However, it is significantly more realistic than Mr. Butson's projections,

⁴ Notwithstanding the predictions of continuing growth in Mr. Butson's report and elsewhere, Sirius' advertising revenue not only declined as a percentage of total revenue in the first quarter of 2007, as compared to the same period in 2006, it declined slightly in absolute dollar terms. See SIR Ex. 57 (2007 1Q 10-Q, at 1) (reporting first quarter 2007 advertising revenue of \$6.7 million, down from \$7.3 million in the same quarter in 2006).

and the resultant differences are quite stark. For example, with respect to total revenue, the differences are as follows (all numbers in millions of dollars):

	<u>Projected Sirius Revenue</u>					
	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>
Butson Model	\$1,076	\$1,552	\$2,008	\$2,428	\$2,807	\$3,153
Difference						

As this chart demonstrates, Mr. Butson has over-estimated Sirius’ revenue during the license term by over || || billion, as compared to the results that we obtained using our model (based on consensus gross adds and advertising revenues). The magnitude of these discrepancies renders Mr. Butson’s model -- and all of the conclusions that he and other SoundExchange experts derive from it -- fundamentally unreliable and misleading.⁵ Further, differences that would otherwise be readily apparent in free cash flow, EBITDA and net income are obscured by Mr. Butson’s use of the extremely high sound recording royalty sought by SoundExchange (the unrealistic subscriber and revenue assumptions substantially offset the high royalties). The disruption to our business that would be caused by higher royalties using realistic assumptions for subscriber and revenue growth (as opposed to Mr. Butson’s assumptions) is discussed below.

Response to Dr. Pelcovits

15. I have reviewed the proposed non-music programming cost benchmark put forward by Dr. Pelcovits in his Amended Written Direct Testimony (“Pelcovits AWDT”). See pp. 8-11. This testimony reflects a fundamental lack of knowledge of the satellite radio business

⁵ Although I have not attempted to catalogue them all in this report, other material discrepancies are apparent when one compares the Butson model and SIR Exhibit 58. For example, SIR Exhibit 58 shows that Sirius will not have positive free cash flow until 2010 as opposed to 2009 as predicted by Mr. Butson.

and includes multiple assumptions that lead to an enormously over-stated result, even if one were to assume that the market prices for non-music content were an appropriate benchmark for a section 801(b) fee. Most notably, Dr. Pelcovits: (i) analyzed a year that will bear no resemblance to the license period at issue in this case, (ii) failed to account for the significant value considered in the contract price of non-music content deals in excess of the value of a pure content license, such as the benefits of associating Sirius with valuable brands and additional promotional benefits, and (iii) failed to offset the expected advertising revenues associated with non-music channels that is not generated from music programming.

16. It is well known in the industry, and by those who purport to follow the industry, that programming costs will not increase in proportion to revenue. For example, Mr. Butson does not show programming costs increasing directly with revenues. Dr. Pelcovits himself recognizes that the non-royalty music programming costs incurred by Sirius and XM will not scale with revenue, AWDT at 3 n.7, but ignores that principle in connection with our non-music programming costs.

17. I start by observing that Dr. Pelcovits' analysis of Sirius' non-music, non-Stern programming costs in 2006 had an obvious omission that caused him to overstate our non-music, non-Stern programming expenditures by \$82.9 million. Although, in adjusting out the cost of our Howard Stern channels, Dr. Pelcovits subtracted the \$224.8 million stock grant that was expensed in January 2006, he failed to subtract the \$82.9 million expense that we also recognized in 2006 for the Stern incentive stock grant. The inclusion of this grant in our 2006 programming expense is discussed on pages 34 and F-30 of the 2006 10-K. If all Stern costs were removed from our 2006 non-music programming costs, the total non-music programming

cost would be [[]]. This would be [[]] of Sirius' revenues from 2006, rather than the [[]] stated by Dr. Pelcovits.

18. Because Sirius' revenues will be lower in 2006 than in any of the years during the license period (as reflected in the projections in SIR Exhibit 58), our non-music programming costs as a percentage of revenue will be higher in 2006 than at any time during the license term. Thus, for example, we project our non-Stern, non-music programming costs to be [[]] of revenue in 2007 and [[]] of revenue in 2010.

19. Further, Dr. Pelcovits' analysis fails to recognize that Sirius obtains substantial value from its non-music programming contracts that it does not receive from the sound recording performance right, such as brand affiliation and promotional benefits. Sirius also enters into its non-music programming deals with the expectation that it will earn advertising revenues that help defray the cost of those deals. Similar advertising revenue is not available from our music programming, which must remain commercial free in order to help us differentiate it from terrestrial radio.

20. It is possible to recreate Dr. Pelcovits' non-music programming cost benchmark analysis to correct for his improper use of 2006 figures to represent the 2007-2012 license term, and his failure to recognize the fact that the cost of our non-music contracts is offset by our advertising sales revenues. I also use our projections of the musical works royalty and our non-royalty music programming costs during the license term, instead of Dr. Pelcovits' estimates. Otherwise, I follow Dr. Pelcovits' method, using our non-Stern, non-music programming expenses. Dr. Pelcovits was correct to exclude the Stern deal, which, as I discuss below, was one of a kind and was made at a critical time in the company's development. The corrected analysis, based on numbers from the updated projections described above, and our split of Stern,

non-Stern costs, is set out in the attached Exhibit 60. As shown in the chart, the weighted average sound recording license fee that results over the entire license term is [[]] of revenue. This analysis does not take into account the many other benefits we receive from our branded non-music content agreements discussed above, which means that the results of this re-analysis still will overvalue the sound recording performance right.

21. While the considerations discussed above are pertinent to all of our branded content deals, there were also unique considerations that affected our decision in October 2004 to enter an into agreement with Howard Stern. At the time, Sirius was lagging far behind XM in subscriber growth, revenue, brand awareness, and most other relevant metrics. We were also lagging substantially behind XM in terms of our critical relationships with auto manufacturers and retailers. After Howard Stern announced his intention to leave terrestrial radio, we were aware that his representatives were having conversations with XM. Given the relatively tenuous state of Sirius' business at that time, and our weakness as compared to XM, we were concerned that the loss of Howard Stern to XM could prove fatal to Sirius' future business prospects. As proven by subsequent events, including the media attention, the effect on our relationships with OEMs and retailers, and the effect on our subscriber base, the signing of Howard Stern was a unique event in the history of our company; nothing before or since has had the same impact.

Disruption

22. Mr. Butson's testimony also suggests that the rate increase proposed by SoundExchange would not be disruptive to our business. See Butson WDT at 3-4. That testimony is wrong, for multiple reasons.

23. First, Mr. Butson based his position in large part on the contention that Sirius was "fully funded," which he apparently defined to mean a non-zero cash balance based on

realization of the assumptions in his model. See Butson WDT at 23 (suggesting that Sirius was fully funded because it had \$792 million in available cash to cover \$783 million in anticipated free cash flow losses). Mr. Butson's analysis fails because, as demonstrated below, he has overestimated Sirius' likely revenues by hundreds of millions of dollars per year. More fundamentally, as the CFO of a public company the size of Sirius, I would not approve a budget that contemplated going down to \$9 million in cash. In my view, such a plan would be irresponsible; I believe that most CFOs would concur. Because the consequences of running out of cash would be so severe, my standard is to maintain an available cash reserve of at least \$100 million, as I believe this to be the functional equivalent of zero in light of the size and complexity of Sirius' business and the uncertainties confronting it. Thus, for multiple reasons, Sirius would not be "fully funded" (or even close to it) if the rate increases proposed by SoundExchange were adopted.

24. A more subtle question is the point at which a rate increase from the present approximately 2.5% rate would be disruptive to our business. At the 0.88% sound recording royalty rate proposed in our direct case, our cash position would reach a low of approximately [[]] million, providing a prudent cushion for running a still-developing business. As set out in Exhibit 59, we have calculated that, using the same assumptions and forecast model discussed above, a sound recording rate rising as high as [[]] would eliminate this safety net, dropping us to the functional zero point in cash reserves discussed above, and would require us to attempt to access the capital markets to fund the rate increase, even assuming no other adverse events or further unanticipated slowdowns.⁶ If we were unable to raise significant additional capital,

⁶ By discussing disruption, I do not mean to suggest in any way that Sirius would consider a rate of [[]] or higher to be reasonable or otherwise compliant with the Section 801(b) factors. The testimony that we have submitted demonstrates why rates at those levels

and/or if the cost of doing so were too great, we would be forced to attempt to compensate for the higher rates by cutting back on other necessary expenses or eliminating capital expenditures that contribute to the growth of the business. Any of these courses would be disruptive to our business. For the reasons discussed above, we have determined that the other theoretical option — a price increase -- simply is not viable in the face of competing with free radio. Lastly, from a competitive perspective, terrestrial radio is a free service that accounts for 97% of radio listening today and does not pay a sound recording royalty. As a fledgling service trying to win customers from free radio, any fee disrupts our ability to effectively compete, adversely affecting us and our ability to generate payments to Sound Exchange.

(Continued . . .)

would not be reasonable.

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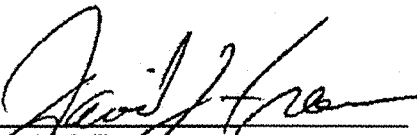
In the Matter of

Adjustment of Rates and Terms for
Preexisting Subscription and Satellite
Digital Audio Radio Services

Docket No. 2006-1 CRB DSTRA

DECLARATION OF DAVID J. FREAR

I, David J. Frear, declare under penalty of perjury that the statements contained in my Written Rebuttal Testimony in the above-captioned matter are true and correct to the best of my knowledge, information and belief. Executed this 13 day of August 2007 at New York, New York.



David J. Frear

CERTIFICATE OF SERVICE

I hereby certify that the foregoing Public Version of UNOPPOSED MOTION TO AMEND WRITTEN REBUTTAL TESTIMONY OF DAVID J. FREAR was served on August 16, 2007 via overnight mail on the following parties:

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