Before the
COPYRIGHT ROYALTY JUDGES
LIBRARY OF CONGRESS
Washington, D.C.

In the Matter of ADJUSTMENT OF RATES AND TERMS FOR PREEXISTING SUBSCRIPTION SERVICES AND SATELLITE DIGITAL AUDIO RADIO SERVICES	Docket No. 2006-1 CRB DSTRA

AMENDED REBUTTAL TESTIMONY OF MARK J. VENDETTI
(ON BEHALF OF XM SATELLITE RADIO INC.)

INTRODUCTION

1. My name is Mark J. Vendetti. I am currently employed by XM Satellite Radio Inc. ("XM") as Senior Vice President of Corporate Finance, and have been employed by XM in this capacity since May 2005. I testified orally concerning XM's financial performance during the direct case phase of this proceeding. That testimony was based on my written direct testimony filed on October 30, 2006, which analyzed the published XM financial results through 2005 and an average of analysts' financial forecasts for 2006 through 2010. This rebuttal testimony is submitted in response to the Copyright Royalty Judges' request for updated financial information,[1] as well as in response to certain of the testimony of SoundExchange witnesses Sean Butson and Michael Pelcovits. The financial information presented in this testimony is based on published XM results through the first quarter of 2007 (attached as Vendetti Rebuttal Exhibits 1 and 2) ((XM SEC Form 10-K for 2006 and XM SEC Form 10-Q for the first quarter of 2007)), XM's mid-year review of its 2007 annual budget (attached as Vendetti Rebuttal

[1] See June 5, 2007 Transcript at 309:11-16.

Exhibit 3), and an updated average of forecasts for the period of 2007-2012 from 19 analysts who cover XM (attached as Vendetti Rebuttal Exhibit 4).

2. Since the filing of my October 2006 testimony and XM's last internal assessment of its future financial performance,[2] several phenomena, most prominently unexpected continued softness in the retail sales market, have caused XM to conclude that it can reasonably expect more moderate growth for the foreseeable future than had been projected. This conclusion is generally in line with the most current analyst projections. More specifically, XM now possesses "aftermarket"[3] sales data for the most recent of its two most important sales periods: the 2006 Thanksgiving to Christmas Season and the 2007 Father's Day/Graduation Season. During these two sales periods, the satellite radio industry generally achieves its highest levels of sales of aftermarket subscriptions and radios for the year. These data reveal that sales of aftermarket subscriptions and radios fell far short of prior internal forecasts. Due to the decline in aftermarket sales, XM's cost of acquiring new subscribers (the "Cost Per Gross Add" or "CPGA") will increase during 2007 beyond prior internal and analyst projections. The apparent persistence of this downturn in the aftermarket, which began in 2006, as compared to XM's projections, suggests that XM's most recent financial projections for the period beyond 2007 will also require revision to reflect an increase in CPGA going forward. Finally, [[

]]

[2] See XM CRB 00006019 ("2007-2011 Long Term Strat Plan *February 1, 2007*") (attached as Vendetti Rebuttal Exhibit 5) (hereinafter "Strat Plan").

[3] In the satellite radio industry, the term "aftermarket" refers to the sale of radios and subscriptions to subscribers who purchase XM-compatible radios at retail outlets, distributors, or through XM's direct sales efforts, as opposed to those subscribers who acquire XM radios and subscriptions through automobile purchases, which are referred to as "OEM" sales.

XM'S INTERNAL PROJECTION PROCESS

3. Each year XM's Corporate Finance Department produces near-term and long-term financial plans to guide the company. These generally include: (i) an annual budget, which guides the company's operations during the year; (ii) a mid-year update on the annual budget, which amends the annual budgetary plan based on six months of actual performance and identifies new business and market trends for the remaining six months of the year; and (iii) a long-term plan, which generally sets forth the company's strategic goals over the next five years. As all parties to this proceeding have recognized, the near-term projections, meaning the annual budget and mid-year update, tend to be more reliable than the company's long-term projections. As I elaborate below, however, even these near-term projections are subject to revision based on unforeseen market developments.

4. Separate from the financial documentation produced in the normal course of business and in conjunction with pending merger-related negotiations with Sirius Satellite Radio Inc. ("Sirius"), XM's management decided in late 2006 to update the long-term projections in order to assist in the analysis and evaluation of the various merger proposals under consideration by the two companies. To accomplish this, XM's Corporate Finance department combined the 2007 annual budget, which was approved by the Board of Directors at its December 15, 2006 meeting, with forward-looking projections consistent with the company's long-term strategic goals for the years 2008-2011. These longer-term projections were not presented to, or approved by, XM's Board of Directors as a long-term plan. The following text appears in the footer of every page of the resulting Strat Plan (Vendetti Rebuttal Exhibit 5): "This document contains only preliminary analysis based on certain assumptions, and does not represent a definitive or approved projection of XM."

CURRENT MID-YEAR REVIEW OF 2007 ANNUAL BUDGET

5. The mid-year review of the 2007 annual budget began in May and was completed on July 19, 2007, when the mid-year update was presented to XM's Board of Directors.[4] The purpose of the update was to adjust and revise the forecasted 2007 budget for the remaining six months of the year. The 2007 mid-year review identified unanticipated and disappointing results in three key financial areas, which are described below. In combination, the impact of these developments, among others, points toward a more modest growth trend for subscribers and progress toward profitability for the foreseeable future than previously anticipated by XM and the analysts covering the company.

Decline in Aftermarket Sales

6. XM's sales of subscriptions through aftermarket channels (i.e., retail stores and outlets) have experienced a considerable decline relative to XM's business plans since 2006. It had been XM's expectation that the decline would be reversed starting in the second quarter of 2007 but this has not materialized and, as shown in the chart below, the aftermarket sector has continued to decline significantly. The actual aftermarket sales are coming in lower than anticipated as set forth in the 2007 annual budget. [[

---

[4] See Vendetti Rebuttal Exhibit 3.

[5] See Vendetti Rebuttal Exhibit 3, slides 2, 3, 29-30.

]]

7. To fully understand the reasons for the decline in XM's aftermarket sales and the deterioration of the aftermarket sales channel itself will require significant study and analysis by XM's management team. What is clear at this time, however, is that the targeted sales growth in this sector as set forth in the February 2007 long-term forecast will not be attained based on current industry data. Consistent with this view, as the table below demonstrates, equity analysts covering the industry currently project aftermarket subscriber additions in the 2008-2012 period considerably below the level set forth in XM's February 2007 long-term forecast.

Overall, XM's guidance of total year-end 2007 subscribers of 9.0 million to 9.25 million is on

---

[6] See Vendetti Rebuttal Exhibit 3, slides 3, 29-30.

[7] See Vendetti Rebuttal Exhibit 3, slide 22.

track with the 2007 annual budget, despite the continuing unanticipated decline in aftermarket sales. But this is due largely to a significant decrease in deactivations, or what is referred to in the industry as "churn," as compared to the 2007 annual budget. [[

]] The maintenance of a churn rate at or around the historic level on a going-forward basis cannot, however, offset what XM and analysts now project to be a persistent fall-off in aftermarket sales.

Increased Cost of Acquiring New Subscribers

8. The continued erosion of aftermarket sales also impacts XM's cost of acquiring new subscribers (referred to in the industry as "Cost Per Gross Add" or "CPGA"). The CPGA business metric is a function of the total money expended to acquire new subscribers (both OEM and aftermarket) divided by the number of gross subscribers acquired. The costs include subsidies and distribution commissions to XM's OEM and aftermarket partners, such as General Motors in the first instance and Best Buy in the second, which vary with the total number of radios sold, as well as advertising and marketing costs, which are more fixed in that they do not necessarily vary with subscriber additions. As I explained in my written direct testimony, subsidy and distribution costs are primarily driven by the volume of XM-enabled vehicles and aftermarket radios manufactured, sold and activated through XM's automotive OEM partners and retail channel.[8] Under its current OEM agreements, XM pays a larger subsidy for new subscribers through the OEM channel than through the retail channel. While gross subscriber

[8] Written Direct Testimony of Mark J. Vendetti, ¶ 24.

additions through the aftermarket channel have declined significantly, gross subscriber additions through XM's OEM partners have remained on track. These new OEM subscribers, however, are acquired at a much higher cost. Thus, due to the unanticipated change in the composition of XM's new subscriber mix, XM's Cost Per Gross Add has increased in comparison to prior internal projections.

9. [[

]] Since the increase in CPGA is related to the decline in aftermarket sales, which is anticipated to have long-term effects on XM's subscriber growth rate, it is reasonable to assume that CPGA will remain at higher levels going forward than previously anticipated. As shown in the table below, analysts covering the industry have already captured this likely effect in their projections.

Decline in Advertising Sales

10. For the past few years, XM's strategy has been to grow a robust advertising sales revenue stream. This strategy has proven to be more difficult to achieve than anticipated. As shown in

---

[9] Vendetti Rebuttal Exhibit 3, slides 2, 3.

the table below, as of the end of the second quarter 2007, [[

]] Developing a new strategy to grow XM's advertising sales will require significant study and analysis by XM's management team.

SUMMARY OF CURRENT ANALYST CONSENSUS PROJECTIONS

11. To provide an update on XM's financial condition and in response to certain financial projections made and/or relied upon by Mr. Butson and Dr. Pelcovits, I directed preparation of an updated average of forecasts, for the period of 2007-2012, from 19 analysts who cover XM. The results are attached as Vendetti Rebuttal Exhibit 4 to this testimony. The first page of

Vendetti Rebuttal Exhibit 4 shows the average of the 19 analyst projection models for this period and the succeeding pages set forth each analyst's projections. The analyst financial models used in the averaging were all produced between March and July 2007 and therefore present the most current market consensus view of XM's projected financial performance.

12. The analyst consensus projections demonstrate that the financial marketplace, like XM, projects a more moderate level of growth for XM in the foreseeable future than was previously anticipated. As shown in the table below, which provides a summary comparison of the current analyst consensus projection as compared to the projection model presented by Mr. Butson in his direct testimony, the analyst consensus projection for 2007 is consistent with XM's 2007 annual budget and XM's 2007 public guidance of 9.0 to 9.2 million year-end subscribers and subscription revenue in the billion dollar range. In the outer years, the summary table demonstrates that the most current analyst projections for XM's 2008-2012 performance, as measured by ending subscribers, subscriber revenue, total revenue, net income and free cash flow, are significantly below those set forth by Mr. Butson (and in turn relied upon by Dr. Pelcovits) in their respective direct testimony.

Summary Comparison of Current Analyst Consensus to Butson's Projections

($ millions)	2007E	2008E	2009E	2010E	2011E	2012E
Ending Subscribers *(thousands)*						
Current Analyst Consensus	9,084	10,764	12,543	14,279	16,146	17,400
October 2006 Analyst Consensus Projection	10,240	12,677	15,051	17,074	N/A	N/A
Butson Projections	10,122	12,322	14,480	16,547	18,436	20,241
Subscriber Revenue						
Current Analyst Consensus	998.2	1,236.4	1,493.3	1,777.4	2,063.2	2,297.1
October 2006 Analyst Consensus Projection	1,127.7	1,475.4	1,818.2	2,138.7	N/A	N/A
Butson Projections	1,109.3	1,421.0	1,751.2	2,093.5	2,438.4	2,781.4
Total Revenue						
Current Analyst Consensus	1,130.6	1,405.7	1,697.9	2,020.2	2,317.8	2,583.5
October 2006 Analyst Consensus Projection	1,239.5	1,633.1	2,010.0	2,369.9	N/A	N/A
Butson Projections	1,266.7	1,635.3	2,028.5	2,433.4	2,840.7	3,243.2
Net Income						
Current Analyst Consensus	(560.8)	(388.6)	(228.3)	(41.1)	137.6	233.5
October 2006 Analyst Consensus Projection	(460.4)	(260.9)	(45.3)	159.2	N/A	N/A
Butson Projections*	(395.8)	(193.5)	26.8	312.2	533.7	756.8
Free Cash Flow						
Current Analyst Consensus	(276.0)	(61.1)	46.6	269.3	435.5	532.2
October 2006 Analyst Consensus Projection	(183.1)	55.6	222.3	396.6	N/A	N/A
Butson Projections*	(245.0)	(55.9)	224.0	504.0	726.0	967.9

** The "Royalties (est.)" line item in the Income Statement of Mr. Butson's XM forecast model (Appendix B to Butson's written testimony) was adjusted to keep performance right royalties flat going forward at 7% rather than including the SoundExchange original rate proposal, which Mr. Butson does in his projection model.*

EFFECTS OF AN INCREASE IN THE SOUND RECORDING RATE

13. In my direct testimony, I addressed the detrimental effects a substantial increase in the sound recording rate would have on XM's financial posture. That testimony was based on published results through 2005 and a consensus analyst projection compiled prior to October 20, 2006. This section of my testimony updates the Court on that perspective based upon the significant decline in XM's projected growth since that time.

14. As indicated in my earlier testimony, XM has budgeted approximately [[ ]] of total revenues for its anticipated sound recording performance royalty payments. Analyst projections capture anticipated sound recording performance royalty payments in an expense line item, "Revenue Share and Royalties," that includes other expenses; they estimate that the total performance royalties of all types – fees paid to SoundExchange as well as to ASCAP, BMI and SESAC for musical works performance – will constitute approximately 7% to 8% of revenues.[10] Of this amount, analysts generally allocate half to the sound recording rights holders and half to the musical work rights holders, or 3.5% to 4% of revenues for each.[11] Page 44 of XM's 2006 SEC Form-10-K (Vendetti Rebuttal Exhibit 1) discloses that XM actually incurred expenses of $37.5 million for musical work and sound recording performance fees in 2006, which reflects 4.0% of total revenues.

15. Using revenues from the analyst consensus figures submitted with this testimony reveals that every 1% increase in the sound recording rate beyond that incorporated in the estimates would generate $111.6 million in sound recording fees over the six-year license period. These costs would have to be absorbed in an environment in which XM is already projected, over the course of the six-year license period, to accumulate losses of $848 million, on top of the $3.2 billion in losses accumulated through 2006. Under the current analysts' assumed sound recording rate of 3.5% to 4.0%, XM is not projected to reach profitability until 2011, when it would post a modest net income of $137.6 million (5.5% of projected 2011 revenues) after 10 years of commercial broadcast operations. Moreover, XM already carries $1.5 billion in debt, $400 million of which is maturing in 2009 and will have to be refinanced. These notes, which

---

[10] See Direct Testimony of J. Armand Musey at 24;Testimony of Sean Butson at 19.

[11] See Direct Testimony of Sean Butson, Appendix B, "Model" page, line 16 (confirming same).

carry a favorable coupon of 1.75%, partially due to the fact that they are convertible to common stock, cannot be refinanced with loans or bonds at a similar rate given XM's junk credit rating. The cost of refinancing of these notes and any incremental borrowing that would be made necessary by an increase in the sound recording rate will likely only be achieved at the cost of an interest rate of approximately 12%, the prevailing rate paid by similarly situated companies with junk credit ratings.

16. The foregoing indicates the financial challenges XM faces even at current, as well as analyst estimated, levels of sound recording performance royalty payments. Substantial increases in the sound recording royalty will only serve to delay, if not jeopardize entirely, XM's ability to become a financially stable and profitable enterprise.

MARKETING VALUE OF OPRAH WINFREY DEAL

17. During the testimony of XM witness Stephen Cook, the Copyright Royalty Judges requested information that would quantify in dollar terms the marketing value of XM's agreement with Oprah Winfrey for the XM channel Oprah and Friends.[12] As the Senior Vice President of Corporate Finance, I am familiar with the financial terms of this deal. Prior to the execution of the agreement, XM analyzed the value of the agreement to XM and produced a presentation entitled "Oprah & XM," which is attached to my rebuttal testimony as Vendetti Rebuttal Exhibit 6. As set forth on page 5 of this presentation, XM views the Oprah agreement as both a marketing and content deal. [[

[12] See June 6, 2007 Transcript at 176-181.

]]

Certification

I declare under penalty of perjury that the foregoing is true and correct to the best of my knowledge and belief.

Dated: Washington D.C .
August 2, 2007

Mark J. Vendetti

Senior Vice President of Corporate Finance
XM Satellite Radio Inc.