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# PUBLIC (REDACTED) VERSION

**GFL-RT-1**

BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, D.C. 20268-0001

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| COMPLAINT OF GAMEFLY, INC. | ) | Docket No. C2009-1 |
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**REBUTTAL TESTIMONY OF SANDER GLICK**
**FOR GAMEFLY, INC.**

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# REBUTTAL TESTIMONY OF SANDER GLICK
# FOR GAMEFLY, INC.

## I. INTRODUCTION AND SUMMARY

My name is Sander A. Glick. I am a Vice-President and co-founder of SLS Consulting, Inc., a Washington, D.C. consulting firm specializing in postal economics. I prepared direct testimony for GameFly, Inc., in this case on April 12, 2010 (GFL-T-1), and defended the testimony during the oral hearing on June 16, 2010 (transcript volumes 3 and 4).

GameFly has asked me to submit my present testimony in response to a number of claims made in the testimony of Postal Service witnesses Nicholas F. Barranca (USPS-T-1), Larry J. Belair (USPS-T-2), Troy R. Seanor (USPS-T-3), and Robert Lundahl (USPS-T-4).

Part II of this testimony responds to, among other points, the Postal Service's implicit and explicit claims that (1) because the processing of Netflix returns is not uniform across the country or always in complete accord with Standard Operating Procedures (SOPs) produced by the Postal Service in this case, the Postal Service does not give special manual processing to most Netflix DVD return mailers; (2) if the Postal Service gives special manual processing to Netflix DVD return mailers, this processing is generally limited to a single manual cull; (3) performing detailed engineering studies, such as those ATR performed for Netflix, of the causes of disk breakage should be a prerequisite to receiving Netflix-like processing; and (4) the terms of service offered to GameFly in the May 17, 2010, letter from USPS attorney Andrew German would, if accepted by

GameFly, result in GameFly receiving similar processing to Netflix. The Postal Service's claims are not accurate.

Part III of this testimony responds to the Postal Service's claim that it gives Netflix return mailers custom manual processing primarily (or solely) because manual culling is a low-cost process. This claim is unsupported and untrue. In particular, the special treatment afforded Netflix returns **[BEGIN USPS PROPRIETARY]** **[BEGIN USPS PROPRIETARY]** Postal Service costs for handling these pieces.

## II. THE POSTAL SERVICE PROVIDES SPECIAL PROCESSING OF NETFLIX RETURNS AT LETTER RATES AND HAS NOT OFFERED THE SAME PROCESSING AT LETTER RATES TO GAMEFLY.

### A. The Postal Service Cannot Dispute That It Continues To Hand-Cull The Vast Majority Of Netflix Return Mailers Entered At Automation Letter Rates.

In its direct case, GameFly offered voluminous documentation that, although Netflix pays only machinable letter rates for its DVD mailers, the Postal Service manually culls the vast majority of Netflix return mail from the automation mail stream and gives it other forms of custom handling, all at no extra charge to Netflix. Citations to these documents appear in paragraphs 57-69 of GameFly's Memorandum Summarizing Documentary Evidence (April 12, 2010). The cited documents are reproduced in volume 4 of the transcript. The Postal Service's testimony, rather than offering any serious challenge to this fact, contents itself with quibbling over peripheral details. For example:

- Messrs. Barranca and Seanor insist that the Postal Service's practice of processing Netflix DVD mail manually and giving Netflix other preferential manual handling was not "uniform" or "pervasive." USPS-T-1 (Barranca), pp. 14-22; USPS-T-3 (Seanor), pp. 10-11.

- Mr. Barranca asserts that the voluminous documents cited by GameFly were "cherry-picked." USPS-T-1 (Barranca), pp. 14-22.

- Mr. Belair testified on cross-examination that the Pacific Area Standard Operating Procedure ("SOP"), one of the many Area and District SOPs and similar directives requiring the culling and manual handling of Netflix return mailers, had been "rescinded." Tr. 9/1652. He professed to be unaware of the Postal Service's admission, in response to an institutional interrogatory, that "current processing practices for Netflix's in-bound pieces in these two areas are substantially similar to those described in the Pacific and Eastern Area SOPs." Tr. 9/1653.

- And Mr. Seanor asserted that the Eastern Area SOP, another SOP produced by the Postal Service in discovery, and described by the Postal Service in response to a follow-up GameFly discovery request as "not rescinded," in fact had never been adopted. Tr. 10/1783-1788. Or, more precisely, "I have no knowledge of it ever being issued." Tr. 10/1787.

These claims merit little weight. While the processing of Netflix return mailers is not exactly "uniform" at every facility or in complete accord with SOPs

that are on the record, neither fact is of any importance. The fact that the Postal Service has manually culled—and continues to manually cull—the vast majority of Netflix return mailers is not contingent on whether the processing of Netflix returns is uniform throughout the country, whether a particular SOP was ever issued, or another one was rescinded. This fact is supported by evidence that appears in the Christensen Associates reports; the United States Postal Service Office of Inspector General (OIG) report of November 2007; a multiplicity of SOPs and standardized procedures issued by numerous Postal Service Districts and P&DCs—none of which the Postal Service disputes; and a wide range of internal Postal Service communications. GameFly Memorandum Summarizing Documentary Evidence (April 12, 2010), paragraphs 57-69.

In any event, the Postal Service has repeatedly acknowledged, in pleadings, interrogatory answers and other sworn testimony *in this case*, that the vast majority of Netflix return mailers still get manual culling:

- The Postal Service admitted in August 2009 that "the amount of manual processing of Netflix mail is likely at least as large as was set forth in the OIG Report." USPS Responses to GFL/USPS-18 and 19(b)-(c). Given the finding of the OIG report that "approximately 70 percent" of the Netflix reply mailers studied by the OIG were manually processed in 2007 (Joint Statement ¶¶ 83-84), this implies that more than 70 percent of Netflix DVD reply mailers receive manual processing at machinable letter rates of postage today.

- Presiding Officer's Ruling No. C2009/1-5 (issued Sept. 28, 2009) ordered the Postal Service to conduct a survey of the prevalence of "signs, placards, posters and similar items that are used to inform Postal Service mail processing personnel where to place DVD reply mailers that have been manually culled." POR 5, p. 19. Instead of complying with this order, the Postal Service stipulated to the existence of these items. USPS Status Memorandum (Feb. 8, 2010) at A-2 (discussing GFL/USPS-31).

- Mr. Seanor acknowledged during his cross-examination that "subordinate facilities in the Eastern District have instructions on how to process DVD mailers," and that the instructions "call for the separation of DVD mailers." Tr. 10/1829-30.

- Mr. Seanor conceded that 70 percent of Netflix return mail "is still pulled away by hand from the automation letter stream," and that the percentage is over 80 percent at some sites. Tr. 10/1804. Mr. Barranca did not disagree. Tr. 10/1875-1876.

### B. The Special Processing Afforded To Netflix Returns Is Much More Than Just One Manual Cull.

In my direct testimony, I identified a number of other forms of special processing, apart from manual culling, that Netflix return mail customarily receives. Tr. 4/654. USPS witnesses Seanor and Belair suggest in their testimony that manual culling is the only activity the Postal Service performs for Netflix return mail, *i.e.,* culling allows Netflix returns to bypass further processing.

USPS-T-2, at 6; USPS-T-3, at 6-7.[1] Their suggestion is contradicted by the Postal Service's own admissions. **[BEGIN USPS PROPRIETARY]**

**[END USPS PROPRIETARY]** USPS Institutional Response to GFL/USPS-162(b). While the processing of Netflix returns was not exactly the same at all of these facilities, Christensen found that manual culling is just the first of multiple, primarily manual, activities that are generally entailed in the processing of Netflix returns.

**[BEGIN USPS PROPRIETARY]**

[1] This same, inaccurate assumption is reflected in **[BEGIN USPS PROPRIETARY]**

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**Table 1. Typical Components of USPS Process For Handling Netflix Returns**

| Category | Number of Times per Piece |
|---|---|
| Manual Culling | [2] |
| Sorting | |
| Facing & Sleeving | |
| Riffling Trays for Accuracy | |

Source: Appendix A, Table A-2 **[END USPS PROPRIETARY]**

Furthermore, because Christensen did not try to model all allied costs directly (*i.e.,* the Christensen Model includes some costs for allied activities using CRA-based proxies)[3], the study did not collect data on all of the allied activities involved in the processing of Netflix returns process. In addition to the above processing steps explicitly modeled by Christensen, the national Netflix SOP requires that Extended Managed Mail (EMM) trays of Netflix returns, the type of tray that the SOP requires for Netflix returns, be brick-laid no more than four layers high into shelved APCs. GFL520-521.[4]

I also would like to respond to two points made by witness Belair and one point made by witness Seanor during their cross-examination. First, Mr. Belair stated that many letter trays – i.e., not just Netflix trays – must be sleeved. Tr.

[2] This figure is higher than the Christensen estimate that 77 percent of Netflix returns were processed manually. A reason for the difference is that some pieces were manually culled, but then processed in an automated fashion.

[3] *See e.g.,* cell P65 in FE Return Scenario 3.xls. worksheet "Orlando".

[4] According to Belair, other trays are sometimes used. Tr. 9/1664.

9/1687. This statement, while correct, misses the point. While many other trays are sleeved by the Postal Service, trays containing pieces that have been sorted on automation do not require the high-cost processing in the "Facing and Sleeving" operation (also referred to by Christensen as "Traying and Sleeving" operation) that Christensen observed for Netflix and Blockbuster. FE Return Scenario v.xls, "Misc." **[BEGIN USPS PROPRIETARY]**

**[END USPS PROPRIETARY]** USPS Institutional Response to GFL/USPS-176.

Unlike trays of Netflix returns, letters that are sorted on automation are faced and trayed in the DBCS operation. Because of this, sleeving trays of letters that have been processed on automation is much less expensive than the Netflix "Facing and Sleeving" operation. For example, the MODS 17 1SCAN cost pool, which "contains costs for [among other activities]…Automatic Tray Sleeving, or Scan-Where-You-Band equipment" was only 0.05 cents per piece for under-one-ounce First-Class Mail single-piece letters in FY 2005. Docket No. R2006-1, McCrery Response to PB/USPS-T22-9; FE Return Scenario 1 v.xls, "SP VV Costs".

Second, witness Belair suggested that culling costs are small because the costs for this activity are fixed. Tr. 9/1685-8. Belair offers no study to support this claim, and it is completely at odds with findings over many years by the Postal Service and PRC that mail processing costs do vary substantially with volume. Furthermore, as I noted in my direct testimony (at page 5), in

developing its cost estimates, Christensen used the Postal Service's lower estimates of the variability of mail processing costs. Using the PRC's higher variabilities would increase the estimated cost of the Netflix return process above that estimated by Christensen.

Third, during cross-examination, witness Seanor discussed the value of manual culling "by the carriers and the collection units out in the field" to plants. See, e.g., Tr. 10/1789 (Seanor). Two clarifications are necessary. Culling by the carrier and the collection units is atypical. According to Christensen's web-based survey to which 348 facilities responded, only fifteen percent of responses indicated that culling is performed at stations/branches, i.e., prior to the mailpieces arriving at processing facilities. GFL1027, 1058. **[BEGIN USPS PROPRIETARY]**

**[END USPS PROPRIETARY]** Also, while the cost of culling at collection units may not hit witness Seanor's budget because it does not occur at the plant, manual culling is not a free good regardless of where it occurs.

### C. Even With All Of Lundahl's Techniques, Automated Letter Processing Still Creates More Damage To DVDs Than Does Manual Processing.

USPS witness Robert Lundahl maintains in his testimony (USPS-T-4) that various techniques researched by his company, ATR, for Netflix can make DVDs much more resistant to breakage in automated letter processing. Mr. Lundahl portrays GameFly as neglectful or irresponsible in not adopting the same techniques. USPS-T-4, at 2.

Mr. Lundahl's testimony is beside the point. I am informed by counsel that the question is not whether Mr. Lundahl's techniques can *reduce* the rate of DVD breakage from automated letter processing. The question is whether the resulting reduction in breakage is great enough to *eliminate* (or come close to eliminating) the difference in breakage rates between automated letter processing and manual processing. If the former method of processing still breaks substantially more DVDs than the latter, then the former is still an inferior form of mail service for DVDs than the latter, and the factual foundation for GameFly's discrimination claim remains. In fact, Mr. Lundahl has *conceded* that his techniques, even if implemented fully, will eliminate only a fraction of the breakage of DVDs caused by automated letter processing.

First, the record in this case makes clear that DVDs suffer higher breakage rates when forced to undergo automated letter processing than when they bypass automated letter processing. This is a *ceteris paribus* or incremental effect: the heightened breakage rates from automated letter processing are *in addition to* the background level of breakage that occurs from other causes. That is why DVD rental companies—not just GameFly—have sought to minimize the exposure of their return mail to automated letter processing.[5]

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[5] *See* Tr. 5/890 (Hodess) (describing GameFly observations); GFL773 (the Round-Trip Disc Mail (RDM) Work Group Minutes: 26 September 2005) ("Disc damage is now becoming the number one issue with RDM [round-trip DVD mail] mailers as more mail is processed on equipment."); GFL1335 (slide from USPS PowerPoint Presentation titled "LSS Project Re-Measure: Return DVD Handling & Damage Reduction" and dated February 24, 2009) ("Automated USPS handling procedures cause a perceived amount of damage to mailers' DVD products causing a large return volume to be processed manually at the mailers' request."); GFL126 (document titled "Netflix and the Round-Trip Disk Mail (RDM) Project") (discussing engineering tests of disk breakage); GFL216 (reporting disk

Witness Lundahl's testimony confirms that automated processing breaks more discs than manual processing. The following excerpts from his testimony and ATR studies make clear that the primary cause of disk breakage is automated letter processing:

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breakage rates from tests); GFL 523 (USPS letter citing Netflix's reluctance to adopt a USPS-designed mailer due to its belief that "processing of their mailers on the AFCS is causing an increase in disk damage" and explaining that Netflix prefers that its "disks are culled at the AFCS and processed manually"); GFL 525 [CONFIDENTIAL](Attachment to previously cited letter detailing the ways that automation processing damages discs); GFL768 ("[T]he overriding issue for Netflix concerned disc damage on the AFCS"); GFL10 (internal USPS memorandum noting that "damaged (broken) disks during processing and/or delivery" were "common problems" reported by Netflix); GFL 771 ("[Blockbuster] expressed concern about damage to the discs in the current Blockbuster design. [Blockbuster] reported an overall damage rate of 3% with the newer envelope designs."); GFL374 (stating, in response to testing of a DVD mailer's proposed envelope design, that "engineering's ongoing experience with the poor machineability of this design indicates that the [DVD mailer's] mailer will sustain damage . . . during processing."); GFL7293 (same); GFL7295 (same); GFL 1485 (October 9, 2005 email from **[BEGIN USPS PROPRIETARY]** **[END USPS PROPRIETARY]** stating that "[c]urrently the only viable solution to scrap reduction is the culling of our returns prior to getting into the automation stream."); Joint Statement at ¶ 102 (noting that Blockbuster formally asked the Postal Service to "immediately implement manual culling and processing of inbound mail pieces for Blockbuster Online" to mitigate the "persistent damage to mailer contents and longer mail duration rates as judged against comparable mailings."); USPS Response to GFL/USPS-82(b) (indicating that Netflix told the USPS that the avoidance of automated processing can reduce breakage rates "with no change in the physical attributes of the DVD, its handling by the customers and employees of the DVD rental company, and the average number of mailing cycles per DVD"); USPS Response to GFL/USPS-82(c) (responding affirmatively when asked if any DVD mailers had "requested that their inbound mailers be handled manually *to reduce breakage rates*" (emphasis added))

- ”DVDs face risks of damage from various types of processing depending, for example, upon the mechanical twists, impacts and turns a particular piece of equipment imparts.” USPS-T-4 at 1.

- “In the end, the vast majority of standard definition DVD failures are caused by the repeated bending stresses from mail handling equipment.” USPS-T-4 at 4.

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**[END USPS PROPRIETARY]**

Although Mr. Lundahl declined to compare the breakage resulting from automated letter and manual processing during cross-examination because he has not studied manual processing, the conclusion that automated processing causes more damage flows logically from his testimony: (1) breakage results from flexing/bending; and (2) manual processing involves less flexing/bending than automated letter processing. USPS-T-4 at 13; Tr. 7/1349, 1356.[6] The reduced breakage resulting from avoiding automated letter processing is also confirmed by **[BEGIN USPS PROPRIETARY]**

**[END USPS PROPRIETARY]**

[6] I am unaware of any evidence that manual processing involves any significant amount of flexing/bending. To the extent that the stacking of trays could stress disks, this is minimized by the containerization methods specified in National SOPs for the processing of Netflix return mailpieces.

Second, Mr. Lundahl conceded during cross-examination that his techniques reduce, but do not eliminate, the increased disk breakage that results from automated letter processing. Tr. 7/1354. He stated that Netflix's adoption of most of the ATR recommendations increased the number of turns (times) that a Netflix DVD could be mailed before breaking by about fifty percent. Tr. 7/1370. A 50 percent increase in the average number of mailings before breakage renders a disk unusable is equivalent to a reduction in per-mailing breakage rates of only about 33 percent.[7] While such a reduction is certainly beneficial to Netflix, it does not come close to eliminating the breakage resulting from automated letter processing. Mr. Lundahl's admission on this point is confirmed by the apparent failure of Netflix, even after adopting many of ATR's recommendation, to rescind its request for manual processing by the Postal Service. Tr. 7/1328 (Response to GFL/USPS-T4-18); Tr. 7/1373-4. Even in 2008 and 2009, after the supposed adoption of Mr. Lundahl's damage-avoidance techniques by Netflix, the company continued issuing its weekly report cards to the Postal Service—along with frequent admonitions to keep breakage down. GameFly Memorandum Summarizing Documentary Evidence (April 12, 2010), ¶¶ 72; Tr. 4/509-512 (Netflix weekly scrap reports).[8]

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[7] The ratio of the average disk life before breakage is the reciprocal of the ratio of the average rate of breakage per turn. For example, increasing the number of times that a DVD can be mailed before it breaks from 10 to 15 increases the life of the DVD (in terms of the average number of mailings before breakage) by 50 percent. This is equivalent to a reduction in the average *per-trip* breakage rate from 10% to 6.7% percent, a reduction of 33 percent.

[8] For the above reasons, Mr. Lundahl's portrayal of GameFly as neglectful or irresponsible in failing to engineer its DVDs according to ATR recommendations (USPS-T-4 at 2) would be completely irrelevant to this proceeding even if true.

### D. The Terms Of The May 2010 "Offer" From USPS Counsel Would Not Give GameFly Service Comparable To What Netflix Receives.

Witnesses Barranca and Seanor argue that a May 17, 2010, letter from Andrew German, a Postal Service attorney, to David Levy, an attorney for GameFly, offers GameFly the same treatment as Netflix:

> GameFly's contention that the Postal Service refuses to provide the mail processing that Netflix' return DVD mail receives is contradicted by the Postal Service' representation that it would provide such processing, if GameFly meets conditions that would place it on a comparable footing with Netflix. The Postal Service has offered to treat GameFly the same as Netflix under certain conditions. In a letter to GameFly's counsel dated May 12, 2010, Andrew German outlined the conditions upon which GameFly would be provided manual processing for return DVD mail comparable to the processing provided to Netflix at the First-Class Mail letter rate.

USPS-T-1 at 31-32 (Barranca); USPS-T-3 (Seanor) at 21.

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But is also unfounded. GameFly does not manufacture DVDs or have the buying power to influence DVD production processes. *See, e.g.,* GameFly response to USPS/GFL-29.

Furthermore, the use of machinable letter rates will be a non-starter for GameFly until the Postal Service's offers Netflix-like levels of manual processing to GameFly return mailers sent at automation letter rates. Even with full implementation of Mr. Lundahl's techniques, the resulting DVD breakage rates would still be unacceptably high. That is what has forced GameFly to use mailers with protective inserts, and to mail them as *flats*. Tr. 5/890, 905, 940-941 (Hodess).

Despite the more limited range of disc-protection options that the Postal Service's actions have allowed GameFly, the company has limited its overall rates of disc breakage by mailing its pieces as two-ounce flats—at much higher postage rates.

This claim is unfounded. First, as GameFly and I have previously explained, the offer does not include any commitment that GameFly will receive the same avoidance of automated letter processing. Tr. 4/654-5; Tr. 5/948, 954-5. To the contrary, Mr. German's letter emphasizes that the Postal Service's offer, if accepted by GameFly, would continue to leave the method of processing GameFly mailers to local discretion. The letter does not commit to instructing the field to cull GameFly with the same frequency that it culls Netflix, even though USPS witness Seanor suggests that a directive is necessary to ensure the same level of culling for GameFly pieces. German Letter at 1; Tr. 10/1811, 1814, 1818-9 (Seanor); Tr. 5/899 (Hodess).[9]

These are crucial omissions. The actual percentage of GameFly return mailers that would be diverted from the automation mailstream, if mailed as letters, is a crucial issue, since the Postal Service's offer would require GameFly to abandon the protection currently offered by its use of flats processing and protective inserts. And the Postal Service's performance to date in providing manual culling to letter-shaped DVD mailers other than Netflix gives no grounds for optimism:

- "77 percent of the Netflix returning DVD envelopes are processed manually compared to Blockbuster's almost 35 percent. Just over 62 percent of Blockbuster's returning DVDs are processed on some form of BCS equipment." USPS Mail Characteristics Study of DVD-

[9] Seanor stated that the instruction would not need to come from Headquarters, but to achieve Netflix-like processing, clearly would require a nationwide commitment.

by-Mail, Survey Instruments, Methodologies, and Results, Christensen Associates, November 2006 (GFL1036).

- "The OIG did not observe any other PRM mailer's two-way DVD return mailpieces being manually processed as much as this specific mailer's pieces were manually processed." USPS Office of Inspector General, Audit Report No. MS-AR-08-001, *Review of Postal Service First-Class Permit Reply Mail* (November 8, 2007) (GFL692).[10]

- During cross-examination, USPS witness Seanor confirmed the culling pecking order – postal employees cull Netflix the most, "tend" to cull Blockbuster at the same time, and (as far as he was aware) don't regularly cull mail sent by other letter mailers. Tr. 10/1821.

Whether these disparities are truly the result of local discretion, as the Postal Service contends, or whether local discretion is just a fig leaf for a headquarters decision to treat Netflix DVD mailers better than the DVD mailers of other rental companies, ultimately does not matter. In either case, an offer that reserves the ultimate choice of processing method to the Postal Service's discretion, rather than committing to a specific and enforceable minimum level of manual processing, is just a warmed-over version of the status quo.

[10] The DVD rental company whose return mailpieces received the most manual processing was Netflix. Joint Statement of Undisputed and Disputed Facts (July 20, 2009), Paragraph 84.

Finally, two of the preconditions that the Postal Service would require GameFly to satisfy in exchange for an empty and unenforceable service commitment would impose additional costs on GameFly for no legitimate reason. Specifically, the Postal Service's offer is conditioned on GameFly's commitment to:

- Take delivery of its mail via caller service at approximately 130 locations (a number much larger than GameFly's current number of pickup points).

- Enter outbound pieces significantly deeper into the mail stream.

Witness Seanor asserts that these terms and conditions specified in the May 17 letter from Andrew German to David Levy for manual culling of GameFly return pieces are reasonable. USPS-T-3 at 21. In fact, they are not.

With respect to the number of mail pickup points, USPS witness Seanor acknowledges that "the positive impact on the outgoing operations from culling Netflix pieces . . . could still be attained regardless of the number of pickup points." Seanor answer to GFL/USPS-T3-27 (Tr. 10/1773). While Mr. Seanor contends that a much small number of pickup points would cause "the Postal Service [to] begin to assume transportation costs which are currently avoided by the number of pickup points being used," these transportation costs are small. In FY 2009, the average transportation cost of a Single-Piece First-Class Mail Letter was only about a penny. FY 2009 Cost Segments and Components and Revenue, Pieces, and Weight Reports. Container loading/unloading costs are

also quite small on a per piece basis, as Mr. Seanor admitted. Tr. 10/1811. Consistent with his admission, the Standard Mail Letter destination entry cost avoidance model estimates that avoiding all container handlings at intermediate facilities through DDU entry only saved 10 cents per pound, *less than one cent for an under-one-ounce letter*, in FY 2009. Docket No. ACR2009, USPS-FY09-13, STD DEST ENT LETTERS.xls, "Summary."

With respect to entering outbound mailers deeper into the Postal Service network, Mr. Belair, with whose testimony Seanor agrees, states that outbound letters containing DVDs are processed on automation. USPS-T-2 at 3; USPS-T-3 at 1. Assuming that outbound letters containing DVDs are processed similarly to other letters (*i.e.,* on automation), there is no reason for any special entry practices.

The absence of any legitimate need for these terms and conditions is underscored by the Postal Service's willingness to offer Netflix manual processing when the number of Netflix mail entry and pickup points was only a fraction of the current number. A September 12, 2002 letter from John Rapp indicates that Netflix at the time had only "twelve hub distribution centers around the country with plans to establish eight additional hub sites by the end of the year." GFL10. Yet, manual processing of Netflix mail was being reported around this time or shortly thereafter. See GFL4 (timeline noting that by June 24, 2002, many USPS sites were "handling [Netflix] return mailers manually (culling from AFCS)"); GFL7-9 (detailing manual processing by September 2003 even though the plants in question were not receiving large volumes of Netflix mail); GFL35

**[BEGIN USPS PROPRIETARY]**

**[END USPS PROPRIETARY]**; GFL428 (July 17, 2003 email reading, "It seems almost everyone is processing this [Netflix] mail manually.")

## III. THE POSTAL SERVICE HAS FAILED TO OFFER ANY RATIONAL JUSTIFICATION FOR DISCRIMINATING BETWEEN NETFLIX AND GAMEFLY ON GROUNDS OF EFFICIENCY.

Despite having no studies to support their position,[11] Postal Service witnesses Seanor and Belair argue that the Postal Service manually culls Netflix returns because culling is a highly efficient process. *See, e.g.,* USPS-T-2 (Belair) at 11, USPS-T-3 (Seanor) at 7.[12] As detailed below, this is crude revisionism.

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[11] "I have not prepared any studies quantifying the cost savings, and I am not aware of any studies prepared by anybody else." Tr. 9/1626 (Belair); also Tr. 9/1627, 1634 (Belair). The lack of analysis to support their positions was perhaps best illustrated by the following colloquy (Tr. 9/1691) during his cross examination:

Q Other than the Christenson Study, which is in the record, you don't have any personal knowledge of what the costs of processing Netflix are?

A Not the exact cost, sir.

Q Not even the approximate costs?

A No.

Q Have you seen any studies quantifying the net cost savings from culling Netflix mail?

A I have not, sir.

Q Have you seen any studies quantifying the value of culling Netflix mail from any service standards?

A Any studies, no.

[12] It is worth noting that Seanor admits that the purpose of the traying and

The Postal Service's own documents confirm that the desire of Netflix for reduced disk breakage, as well as the Postal Service's own desire to avoid jams and other processing problems[13] were—and continue to be—the main reason for the Postal Service's special treatment of Netflix DVD return mailers.

The notion that this custom manual treatment is a low-cost process is, as the Postal Service's witnesses admitted, unsupported by any study or data. To the contrary, using the Christensen model, I show below that manual culling and related special handling of DVD return mailers is on balance **[BEGIN USPS PROPRIETARY]** **[END USPS PROPRIETARY]** as costly as automated letter processing.

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containerization-related aspects of the Netflix process is to reduce mailpiece damage, not to advance internal operation goals: "My understanding is that the guidelines were issued to decrease the possibility of mailpiece damage, due to the way letter trays or flats trays (tubs) were stacked without the appropriate tray sleeve or lid." USPS-T-3 at 10.

[13] The propensity of Netflix returns to cause jams and other processing problems stems from another aspect of the special treatment the Postal Service provides to Netflix: allowing Netflix to pay machinable letter rates on its returns. Specifically, in November 2007, the OIG found that, regardless of Domestic Mail Manual requirements, Netflix return mailpieces in practice "are not machinable." The OIG recommended that the "Acting Vice President, Pricing and Classification . . . [c]oordinate with the Vice President, Engineering, on a Domestic Mail Manual (DMM) revision to the Nonmachinable Criteria DMM, Section 101.1.2 in order to identify additional nonmachinable characteristics and physical standards for First-Class letter-size mail with the same design and general characteristics of the [Netflix] mailpiece." GFL685, 696. Three years later, the Postal Service has not yet done so. "I don't think anything has been done as a result of that audit." Tr. 10/1885 (Barranca). .

### A. The Postal Service's Main Reasons For Manual Processing Of Netflix DVDs Are To Reduce DVD Breakage, Jams, and Other Processing Problems.

As documented in studies performed by the Postal Service's Office of Inspector General (USPS OIG) and on behalf of the Postal Service, Postal Service SOPs, and other USPS documents, the primary purposes of the special processing provided by the Postal Service to Netflix are to minimize DVD breakage, jams, and other processing problems.[14] Below are relevant excerpts that document this point and make clear that Netflix returns do not process well on automation.[15]

#### 1. November 8, 2007 OIG Report – *Review of First-Class Permit Reply Mail*

- "[E]mployees manually process approximately 70 percent of the approved First-Class two-way DVD return mailpieces from one DVD rental company because these mailpieces sustain damage, jam equipment and cause missorts during automated processing." GFL685.[16]

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[14] According to Belair, Netflix requested one aspect of the special processing that it receives – the sleeving of its trays prior to dispatch – to reduce loss (theft) as well as breakage. USPS-T-2 at 19.

[15] As an aside, I have previously explained that the Christensen model likely understates the cost resulting from Netflix pieces jamming postal equipment. GFL-T-1 at 5-6; Response to PR/GFL-T1-1. This position was strengthened by the testimony of witness Seanor, who pointed out during cross examination that (1) Netflix returns have a tendency to jam in the Advanced Facer Canceller System ("AFCS"); and (2) jam rates have a significant effect on overall productivity. Tr. 10/1797-1798.

[16] The one DVD rental company is Netflix. Joint Statement of Undisputed and Disputed Facts (July 20, 2009), Paragraph 84.

- "[A]pproximately 70 percent of one DVD rental company's approved First-Class two-way return mailpieces are manually processed. The Postal Service manually processes such a significant number of these mailpieces because of the nonmachinablility of the envelope design. This design uses a floppy leading edge, which often sustains damage, causes jams in equipment, and missorts during automated processing." GFL690.

- "[O]perations personnel told the OIG that the return mailpieces were manually pulled to avoid damaging the mailpiece, jamming the mail processing equipment, and missorting during processing." GFL692.

- "Engineering's testing of this and similar mailpieces has consistently shown that this type of mailpiece is not machinable. Engineering has noted that mailpieces with this design 'will sustain damage, cause jams, and be missorted.'" GFL695-96.

### 2. Letters From USPS Engineering Stating that Mailpiece Designs Identical or Substantially Similar to the Netflix Mail Piece Are Not Machinable

- "This mail piece design is being processed everyday throughout the Postal system with very poor results. Engineering's ongoing experience with the poor machineability of this design indicates that the … mailer will sustain damage, cause jams and be mis-sorted during processing. This will cause operations personnel to remove the mailers from the automation mail stream and handle them manually."

GFL7287. (The same quotation also appears at GFL374, GFL7278-9, GFL7293, 7295 and (in part) Tr. 4/142 (USPS answer to GFL/USPS-122).[17])

### 3. Christensen Reports, August 2006 and November 2006

- "Often, employees cull the easily identifiable bright colored envelopes from the automated mail stream. Some supervisors in mail processing facilities believe these pieces will not run correctly on automation machinery based on their experiences working with this equipment, or feel that the risk of damage, missorts, or rejects justifies their removal from the automated processing stream." GFL1025.

- "Already during the preliminary site visits, Christensen Associates staff were made aware of the deficiencies in the design of the Netflix return envelope. Many more complaints were heard in plants about the Netflix return envelope than the issues with the slot and sticker on the outbound envelope. By the time the Netflix envelope has made its way to the subscriber and back to the plant, the envelope has aged to the point that a flap has developed on the lead edge of the piece (due to the fact that the DVD is on the trailing edge). This flap tends to fold over when processed on the machinery, causing damage, jams, missorts, and rejects." GFL935.

[17] The mail piece design that is being processed everyday throughout the Postal system with very poor results is the Netflix mail piece design. USPS Institutional Response to GFL/USPS-122.

- "Larger design issues, such as the flap on the lead edge of the Netflix envelopes, have led many plants to abandon automated processing of DVDs due to the increased risk of jams, missorts, rejects, and damage." GFL936.

- "[T]he complaint heard more than any other was over the long flap on the lead edge of the Netflix return envelope….On the return trip the leading flap often becomes bent, causing damage, rejects, and missorts on automation equipment." GFL1025.

- "Thirty-two percent of respondents who manually process Netflix return DVDs indicated that Netflix has asked them to manually process its return DVD envelopes. Respondents again indicated that torn envelopes are the most prevalent form of damage to DVD-by-mail pieces on the return trip from the subscriber to the rental company." GFL1029.

**4. Comments From Site Personnel Quoted in Christensen Reports**

- "'We receive Netflix from [another facility] containerized in large letter trays. We then sort these manually to the surrounding Post Offices. There seems to be some jams and some damage if we process these in automation. To protect all customers involved from damage to the DVD manual sorting seems to be the best option.'" GFL1029.

- "'Netflix return envelopes sort poorly due to design. The leading edge of the mailpiece lacks any rigidity, and therefore can be easily missorted by the DBCS.'" GFL1030.

- "'Very few damaged Blockbuster envelopes – the envelopes are designed more effectively than Netflix.'" GFL1029.

- "'Blockbuster's mailpiece design is far superior when compared to Netflix. Since the envelope size is the same size as the DVD, damage is not an issue.'" GFL1029.

- "'[Blockbuster] envelopes have a sturdy firmer edge, more compacted-sort better on automation machine. Do not see as many damaged (if any) pieces as NetFlix which get damaged due to floppy edge getting caught in machinery.'" GFL1030.

- "'At this time we are pulling return Netflix out of the automated mail stream to manual operations. Packaging is too large for the DVD inside. Blockbuster, for instance, has an envelope appropriately sized to fit the DVD inside. Therefore, the envelopes run well in automation.'" GFL1030.

- "'Blockbuster DVDs envelopes are a better automation compatible mail piece than Netflix.'" GFL1029.

- "'Blockbuster DVDs are sorted on the DBCS, unlike Netflix [which] is pulled out before going through the machine. Blockbuster's return envelope is much better than Netflix's.'" GFL928.

- "'Blockbuster DVDs have an envelope which is a better design than Netflix so very few are damaged. Blockbuster DVDs run well on automation.'" GFL929.

### 5. Postal Service Standard Operating Procedures

#### a. February 15, 2005 National Standard Operating Procedure

- "Netflix believes stacking weight to be a possible contributor to DVD damage. Upon receipt of this letter, please ensure consistent application of the following policy:

  - Netflix return mail placed in EMM trays
  - Netflix EMM trays placed in General Purpose Mail Containers (GPMCs)

The added support of the EMM trays and the GPMC center shelf will minimize the possibility of damage to Netflix products." GFL520.

#### b. May 9, 2005 National Standard Operating Procedure

- "We have found that low product damage rates are a direct result of full compliance with policies previously issued from headquarters….The required Mail Transport Equipment (MTE) for DVD return mailings is

the Extended Managed Mail (EMM) letter tray. The EMM tray's higher profile sidewalls enable the tray to be completely filled without the product exceeding the tray height, thus protecting the mail piece from damage….Regardless of the equipment type, DVD return trays are never to be stacked more than four layers high." GFL521.

#### c. March 1, 2005 Pacific Area and March 3, 2005 Eastern Area Standard Operating Procedure[18]

- "To minimize jams and DVD breakage, 775 Flat tubs…are to be set up adjacent to every piece of equipment…which may be used to initially cull Netflix returns….As Netflix believes that stacking weight is also a contributor to damaged DVDs, Mail Handlers will sleeve the Extended Managed Mail Letter Trays (EMM) and stack them into General Purpose Mail Containers (GPMCs)…." GFL527-528, 536.

### 6. Other documents

GameFly has cited many other Postal Service documents—including SOP-like pronouncements issued by District and P&DC officials, internal emails, and other candid assessments by Postal Service managers—that confirm the central importance of minimizing DVD breakage and jams as the reason for

[18] The Eastern Area Standard Operating Procedure has not been rescinded. Institutional Response to GFL/USPS-106 (Tr. 10/1893-1894). As discussed above, the Postal Service now disputes that it was ever issued. Also, while the Pacific Area Standard Operating Procedure has been rescinded, the process remains the same. *Id*. The current status of these documents, however, has no effect on the rationale they state for culling Netflix pieces.

manual culling and special handling of Netflix DVDs. GameFly Memorandum Summarizing Documentary Evidence (April 12, 2010), ¶¶ 57-64 (citing Postal Service documents).

### B. There Is No Rational Cost Or Service Justification For The Preference That Netflix Receives.

#### 1. The Postal Service Has Already Conceded This.

As explained above, the main reasons for the culling of Netflix pieces are to reduce DVD breakage, jams, and other processing problems, not because culling is a low-cost process. **[BEGIN USPS PROPRIETARY]**

**[END USPS PROPRIETARY]**[19]

The Postal Service has also conceded that meeting service standards is not a major reason for manually culling Netflix returns:

[19] The incremental cost of the special treatment Netflix receives is properly calculated in comparison to the cost of a fully machinable Netflix return that is sorted on letter automation. This is because, consistent with the OIG's recommendation (which the Postal Service still has not acted upon three years later), Netflix returns should only be eligible for the 44-cent rate that it pays if truly machinable. GFL696. Allowing Netflix to mail nonmachinable pieces at machinable letter rates is part of the special treatment Netflix receives.

> The Postal Service disagrees with [the] statement that [a large portion of Netflix mail must be handled manually to meet service standards].

USPS institutional answer to GFL/USPS-67.

### 2. The Modeled Cost Of The Netflix Return Process Is Much Higher Than Automated Letter Processing.

The Christensen Associates cost models confirm that these admissions are correct. As detailed in Appendix A, Table A-3 (below), I estimated the cost of automated processing of Netflix returns (assuming machinability) by modifying the mail flows in the Christensen Associates Netflix returns cost model to reflect this scenario. In performing this analysis, I used four assumptions about the automated letter processing mail flow:[20]

- Processed on Advanced Facer Canceller System (AFCS)
- Outgoing sort on Delivery Bar Code Sorter (DBCS)
- Incoming sort on DBCS[21]
- Manual sortation of rejects

For consistency with the Christensen method, I used older DBCS read/accept rates – those in the Netflix outbound cost model that are identified as being from Docket No. R2005-1, USPS-LR-K-68 – in determining the number of

[20] No delivery point sequencing is necessary for Netflix returns. Tr. 9/1682.

[21] To the extent that there is a Netflix separation in the Outgoing sort scheme, incoming sortation would be avoided (further reducing the cost of this scenario).

pieces that are not accepted by the machine and thus require manual sortation. This overstates manual sorting costs because those accept rates were based upon 1999 data and substantially understated. *See* Docket No. MC2007-1 Op., ¶¶ 1004-1005.[22]

As Table 2 below shows, the average cost of the Postal Service's current methods of processing Netflix returns is **[BEGIN USPS PROPRIETARY]** **[END USPS PROPRIETARY]**[23]

[22] Also, note that the read/accept rates used to estimate the cost of Netflix outbound mailpieces were also higher than the read/accept rates that I used in my calculations. Netflix Model (FE Outbound v.xls), worksheet "DBCS DPS Cost", columns N and Q.

[23] During cross-examination, Belair criticized the Christensen study because "[i]t did not take into account the actual culling at a customer service operation, being that it did not do a cost average of that process." Tr. 9/1716. Mr. Belair appears to be referring to Christensen's use of the same unit culling cost for pieces that were culled at the delivery unit and at the dock of the processing facility. This concern is of minimal importance. As explained above, the majority of culling occurs in processing operations, not customer service operations. Also, it seems unlikely that the manual culling productivity at stations/branches would be substantially different from that at processing facilities.

**[BEGIN USPS PROPRIETARY (NUMBERS ONLY)]**

**Table 2. Modeled Cost of Netflix Returns**

| Category | Modeled Cost (Cents) | Netflix Return Process Cost Premium |
|---|---|---|
| Machinable / Processed on Automation | | |
| Current Netflix Returns Process | | |
| Christensen Scenario 2 | | |
| Christensen Scenario 1 | | |
| Christensen Scenario 3 | | |

Source: Appendix A, Table A-1

**[END USPS PROPRIETARY (NUMBERS ONLY)]**

## CONCLUSION

As explained above, the record clearly shows four important points: (1) the Postal Service provides special processing for the vast majority of Netflix returns at machinable letter rates; (2) the special processing, which is much more than just a single cull, is costly; (3) the purpose of the special processing is to reduce DVD breakage and processing problems that result from the poor design of Netflix's return mail piece; and (4) the Postal Service has not offered the same special processing to GameFly at machinable letter rates.