

PUBLIC (REDACTED) VERSION

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

COMPLAINT OF GAMEFLY, INC.

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Docket No. C2009-1

POST-HEARING BRIEF OF GAMEFLY, INC.

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POST-HEARING BRIEF OF GAMEFLY, INC.

GameFly, Inc., respectfully submits its post-hearing brief.

INTRODUCTION AND SUMMARY

This case is about the caste system that the Postal Service maintains among its customers in the DVD rental industry. The industry has a common problem: processing DVD return mailers in the Postal Service's automated letter processing equipment causes unacceptable rates of DVD breakage. And the Postal Service has a problem with DVDs too: the Postal Service has approved the Netflix and certain other mailer designs for machinable letter rates even though the designs are effectively nonmachinable.

But the Postal Service's response to these problems has been highly selective. To Netflix, the Postal Service has offered an array of preferential treatment—including hand-culling, diversion from the automated letter stream, and hand processing—at no extra charge. The Postal Service, however, has refused to offer similar arrangements to smaller DVD rental companies, including GameFly. Disfavored customers like GameFly can avoid automated letter processing of DVD return mailers only through the costly workaround of mailing and receiving DVD mailers as two-ounce flats. The result is that GameFly must pay flats rates—and the second ounce charge—just to achieve the bypass of letter automation that Netflix enjoys despite paying only a one-ounce machinable letter rate. The extra postage is \$1.22 per round trip.

A number of Postal Service employees have privately expressed concern since 2002 that the disparate treatment of DVD rental companies is unfair, unduly discriminatory, and contrary to the Postal Service's own economic interests. But headquarters management has been unwilling to provide the same level of service to other DVD rental companies. And so the preferences for Netflix have continued.

This disparate treatment violates the antidiscrimination provision of the law, 39 U.S.C. § 403(c). First, Section 403(c) forbids the Postal Service from making "any undue or unreasonable discrimination among users of the mails, nor shall it grant any undue or unreasonable preferences to any such user." This prohibition covers not only discrimination in pricing, but also discrimination in the quantity or quality of service.

Second, GameFly and Netflix are similarly situated within the meaning of Section 403(c). The differences between the two companies' mail and mailing operations, for purposes of this element of Section 403(c), are immaterial.

Third, the Postal Service has failed to establish any rational and permissible basis for the discrimination. The Postal Service cannot avoid responsibility for discrimination on the theory that employees in the field were responsible for the discrimination. Section 403(c) bars all undue discrimination, not just discrimination resulting from headquarters decisions. Second, Postal Service headquarters is directly implicated in the discrimination. Headquarters officials made the threshold decision to approve Netflix's nonmachinable DVD mailers as machinable. And headquarters officials have at least knowingly acquiesced in the discrimination occurring in the field, even though a headquarters directive could have stopped the discrimination at any time.

The preferential treatment given to Netflix mail is also unjustified by any cost savings from manual processing. Although the Postal Service has speculated that such cost savings may exist, the Postal Service admitted in discovery that **[BEGIN USPS PROPRIETARY]** **[END USPS PROPRIETARY]** Moreover, internal Postal Service analyses produced in discovery—especially the 2006 Christensen Associates report—confirm that the net effect of processing Netflix reply DVD mailers manually is to increase the Postal Service’s costs by a factor of **[BEGIN PROPRIETARY]** **[END PROPRIETARY]**.

The notion that variations in “local conditions” justify the preferences given to Netflix is another crude exercise in revisionism. The Postal Service has offered no data to support this hypothesis, and headquarters officials have repeatedly overridden local management discretion by imposing national operating procedures that favor Netflix.

Differences in the volume, length of travel and other operating characteristics of Netflix and GameFly mail have only a minor effect on costs, and thus cannot serve as a justification for the discrimination.

Nor can the discrimination among DVD rental companies be justified on the theory that the Postal Service lacks the capacity to provide Netflix-level culling, manual processing, and other special treatment to all DVD rental companies. This defense is factually unsupported and would be insufficient as a matter of law even if factually supported. Courts and regulators have held repeatedly that capacity constraints do not justify discrimination among customers; limited capacity must be apportioned in a fair and evenhanded fashion.

The Postal Service's discriminatory treatment of Netflix and GameFly mailpieces also cannot be justified as a means of meeting service standards or critical dispatches. The Postal Service expressly rejected this claim in discovery.

Finally, the preferences given to Netflix also violate the filed rate doctrine because the preferences have never been published in the Mail Classification Schedule ("MCS"), the Domestic Mail Manual ("DMM"), or any other publicly available document. To the contrary, many of the preferences, including systematic culling and manual processing, are at odds with the Postal Service's published classifications.

For these and other reasons, the Postal Service's practice of giving Netflix custom processing of DVD return mailers at no extra charge, while denying the same terms to GameFly and other smaller DVD rental companies, constitutes unlawful discrimination under 39 U.S.C. § 403(c) and other provisions of Title 39.

The Postal Service's longstanding failure to cure the discrimination requires that the Commission order the Postal Service to end the discrimination. GameFly proposes that the Commission order the Postal Service to implement one or both of the following remedies:

- (1) The Postal Service should be directed to offer every other DVD rental company manual culling and manual processing of DVD mailers entered at machinable letter rates to the same extent that Netflix receives. This remedy must be defined in terms of a measurable and enforceable quantitative outcome—i.e., at least 80 percent of the customer's DVD volume must be diverted from automated processing—not just in general

or aspirational terms. The manual processing must include each of the elements commonly provided to Netflix, including: (1) culling by collectors, (2) culling by Associated Offices and Stations, (3) culling before and after dual pass/rough cull, (4) culling by AFCS operators, (5) exclusive use of EMM trays (special trays that are deeper than ordinary trays), (6) sleeving of the EMM trays as a matter of practice, (7) exclusive use of shelved all-purpose containers ("APCs"); and (8) placing the EMM trays in the APCs in bricklaid orientation. The remedy must be implemented through a headquarters directive or another directive of national scope and effectiveness.

Moreover, there must be periodic reporting to the Commission to provide current and precise data on the extent to which the Postal Service is actually achieving the minimum required level of manual processing. If the rate of manual processing falls below the target, then the alternative remedy discussed below (reduced rates for flat-shaped DVD mailers) should take effect immediately.

- (2) Alternatively, the Postal Service should be required to publish a reduced automation rate for *flat*-shaped DVD mailers sent and received by GameFly, with the rate set to produce an average per piece contribution to institutional costs equal to the per piece contribution that the Postal Service receives from Netflix DVD mailers entered at letter rates. As GameFly witness Glick explained in his direct testimony, a rate for flat-shaped DVD mailers set in this way would be approximately one dollar per

round trip before application of any presort discounts. This alternative rate should be made available to other DVD rental companies too.

I. STATEMENT OF FACTS

A. The DVD Rental Industry

1. GameFly

GameFly, founded in 2002, is engaged in the online rental of video games. The company is incorporated in Delaware and headquartered in Los Angeles. The game DVDs offered for rental by GameFly are formatted for the Playstation 3, Playstation 2, PSP, Xbox 360, Xbox, Wii, GameCube, Nintendo DS and GameBoy Advance. GameFly offers more than 6,000 titles for rental. Joint Statement of Undisputed and Disputed Facts (July 20, 2009) (“Joint Statement”) ¶¶ 1-6.

GameFly charges subscribers by the month, not by the game. For a flat monthly fee, a GameFly subscriber may rent as many games as desired up to a maximum of four games at any one time, and play them as long as desired, with free shipping, no due dates and no late fees. As of this date, a monthly subscription price of \$15.95 a month (plus any applicable state or local tax) allows a subscriber to rent one game at a time from GameFly. A monthly subscription price of \$22.95 a month (plus tax) allows a subscriber to rent two games at a time. A monthly subscription price of \$29.95 a month (plus tax) allows a subscriber to rent three games at a time. A monthly subscription price of \$36.95 (plus tax) allows a subscriber to rent four games at a time. When the subscriber returns a game to GameFly, GameFly mails to the subscriber the next game previously chosen by the subscriber. *Id.* at ¶¶ 7-9. Subscribers also have the option of

buying most games, rather than returning them. *Id.* at ¶ 10. Consumers subscribe to GameFly, and maintain and update lists of desired games, through the company's web site, www.gamefly.com. Joint Statement ¶ 11.

Most of the games rented and sold by GameFly are recorded on DVDs. Other games are recorded on media contained in plastic cartridges; such games are beyond the scope of this Complaint, which relates to the handling of DVD mail. Joint Statement ¶ 13.

GameFly competes with other DVD video game by mail rental companies with similar business models (e.g., Gamerang and GottaPlay); weekly rental companies (e.g., Blockbuster and Hollywood); and sell-through vendors (e.g., GameStop, Best Buy, Target and Toys R Us). Joint Statement ¶ 14.

GameFly distributes its video game DVDs to subscribers via First-Class Mail entered as single-piece flats. GameFly currently enters these mailings at Postal Service facilities in Los Angeles, Pittsburgh, Tampa, and Austin, the four cities where GameFly has shipping centers. GameFly pays the outbound postage for its DVD mailings to rental subscribers and purchasers at the time of mailing. Rental subscribers return video game DVDs to GameFly in preaddressed reply mailers via First-Class Mail Business Reply Mail. GameFly pays the postage and fees for inbound DVD mailings through a Business Reply Mail account with the Postal Service. Joint Statement ¶¶ 15-19.

GameFly uses a two-way DVD mailer. The outer face of the mailer is addressed to the subscriber. To use the mailer for the return trip, the subscriber tears off the outer

face to reveal an inner face with the BRM indicia and a GameFly mailing address. Joint Statement ¶¶ 20.

In June 2009, GameFly mailed approximately 633,000 DVDs to its subscribers, and received approximately 569,000 DVDs in return mail from its subscribers. GameFly's monthly mail volume increased by approximately 120 percent from July 2006 to June 2009, a compounded annual growth rate of 30 percent. Joint Statement ¶¶ 21-22.¹

2. Netflix

Netflix, Inc. ("Netflix") also engages in the DVD rental by mail business. Netflix offers its subscribers movies rather than video games. Netflix is the largest DVD rental company, and the largest sender and receiver of DVDs, in the United States. Joint Statement ¶ 64; Tr. 4/351 (GFL733 (second slide)); Tr. 4/515 (GFL73673).

Netflix generally mails its DVDs to subscribers at the presorted letter rates within First-Class Mail. Netflix pays the postage for these mailings at the time of mailing. Subscribers return the DVDs to Netflix in preaddressed reply mailers via First-Class Mail Permit Reply Mail ("PRM"). Netflix pays the postage for these return mailings. Round-trip DVDs are returned to Netflix as one-ounce letters at a rate of 44 cents in postage, i.e., the one-ounce single-piece letter rate. Joint Statement ¶¶ 64, 66-71.

¹ GameFly volume figures for August 2010 are roughly the same as in June 2009: approximately 617,000 DVDs mailed to subscribers, and 595,000 returned from subscribers.

Netflix, like GameFly, uses a two-way DVD mailer. The outer face of the mailer is addressed to the subscriber. To use the mailer for the return trip, the subscriber tears off the outer face to reveal an inner face addressed to Netflix. Joint Statement ¶ 65.

According to Netflix's website, it currently has 58 distribution centers. Joint Statement ¶ 72.

3. Blockbuster

Blockbuster Inc. ("Blockbuster") also engages in the DVD movie rental by mail business; it also recently began offering DVD video games as well. Blockbuster is the second-largest DVD rental company, and sender and receiver of DVDs by mail, in the United States. Joint Statement ¶ 93; Tr. 4/351 (GFL733 (second slides)); Tr. 4/515 (GFL73673).

Blockbuster generally mails its DVDs to subscribers at presorted First-Class Mail rates. Blockbuster pays the postage for these mailings at the time of mailing. Joint Statement ¶¶ 95-97.

Blockbuster uses a two-way DVD mailer for mailings of movie DVDs. The outer face of the mailer is addressed to the subscriber. To use the mailer for the return trip, the subscriber tears off the outer face to reveal an inner face addressed to Blockbuster.

Blockbuster also uses a two-way DVD mailer for video games. Subscribers return the DVDs to Blockbuster either in preaddressed reply mailers via First-Class Mail Qualified Business Reply Mail ("QBRM"), or by hand-delivery to a Blockbuster retail store. (Prior to June 2008, Blockbuster mailers that were returned in the preaddressed

reply mailers through the mailstream were paid via First-Class Mail Business Reply Mail.) Joint Statement ¶¶ 94, 98-99.

Round-trip movie DVDs are returned to Blockbuster as one-ounce letters that pay the High Volume QBRM rate of 42.4 cents. Blockbuster pays the postage and QBRM fees for these return mailings. Joint Statement ¶¶ 100-101.

4. Other DVD rental companies

The DVD rental industry includes a number of other firms that send and receive rental DVDs by mail. **[BEGIN PROPRIETARY]**

[END PROPRIETARY]

B. The Common Industry Problems: Automated Letter Processing of DVD Mailers Breaks DVDs. And Many Mailer Designs, Including Those Of Netflix, Jam USPS Mail Processing Equipment.

A movie or game DVD is small and light enough that it can be mailed in a lightweight mailer, with the combined mailpiece qualifying as a one-ounce letter. Joint Statement ¶ 25; USPS response to GFL/USPS-58 (C218). The bending stresses and impacts to DVD mailers during their travel through automated letter processing equipment produce high rates of disc breakage, however. Moreover, many DVD mailers—including those used by Netflix—tend to jam the equipment.

1. Disc breakage

Processing DVD return mailers in automated letter processing equipment, however, causes high rates of DVD breakage. See Joint Statement ¶ 27 (“DVDs

enclosed in lightweight mailers, when processed on Postal Service processing equipment, can experience breakage.”); Glick Rebuttal (GFL-RT-1) at 9-13 (Tr. 12/2018-22) (citing Postal Service documents); Tr. 4/223 (GFL216) (reporting disc breakage rates from tests); Tr. 4/312 (GFL 525); Tr. 4/437 (GFL7229) (ATR report); 452 (GFL7244) (ATR report). These breakage rates are costly to DVD rental companies. Major DVD rental companies—including Netflix, Blockbuster, and GameFly—have tried to work with the Postal Service to obtain lower breakage rates. See, e.g., Tr. 4/354 (GFL768); Tr. 4/375-76 (GFL1484-1485); 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”) (C234-235). We discuss in turn the evidence from the Postal Service, Netflix, Blockbuster and GameFly.

USPS experience. Postal Service employees have acknowledged repeatedly that automated letter processing damages DVDs. See Tr. 4/357 (GFL773) (the Round-Trip Disc Mail (RDM) Work Group Minutes: 26 September 2005) (“Disc damage is now becoming the number one issue with RDM mailers as more mail is processed on equipment.”); Tr. 4/370 (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.”); Tr. 4/214 (GFL126) (document titled “Netflix and the Round-Trip Disk Mail (RDM) Project”) (“these tests suggest that if RDM disks are processed completely within letter automation in both directions, they would suffer losses due to cracking in excess of 5 percent per round trip.”); Tr. 4/537-39 (GFL77696-98) (same); Tr. 4/217-234 (GFL 210-227) (reporting a breakage rate of 4.5 percent per

trip for a test sample of DVDs); Tr. 4/486-608 (GFL 7429-51); Tr. 4/385 (GFL7149) (quoted in USPS response to GFL/USPS-119) (explaining that the cause of DVD breakage appears to be repeated bending of DVDs during their travel through DBCS and AFCS letter processing equipment); USPS response to GFL/USPS-82(b) (indicating that Netflix told the Postal Service 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”) (C234-235).

Netflix experience. Since 2002, Netflix return mailers have suffered unacceptably high rates of DVD breakage whenever processed on automated letter processing equipment. Almost immediately, many mail processing sites were “reporting problems,” and had begun “handling the return mailers manually (culling from AFCS).” Tr. 4/159, 162-163, 237, 286 (GFL4, GFL8-GFL9, GFL272, GFL460).

In September 2002, **[BEGIN PROPRIETARY]**

[END PROPRIETARY] noted that “damaged (broken) disks during processing and/or delivery” were “common problems” reported by Netflix. Tr. 4/164 (GFL10). By June 2003, USPS Operations determined that the primary problem was with the incoming DVD mailers (from customer to Netflix). See Tr. 4/300-01 (GFL509-10).

In late 2003, Postal Service headquarters officials issued a directive to the field requiring outgoing Netflix mailpieces (from Netflix to customer) to be processed on automation equipment. See Tr. 4/286 (GFL462) (letter from **[BEGIN PROPRIETARY]**

[END PROPRIETARY] to Area, Plant and District managers, dated

December 18, 2003).² **[BEGIN PROPRIETARY]**

[END

PROPRIETARY] Similarly, in September 2004, a Postal Service employee reported that “they are noticing an increase in breakage [in Netflix DVDs]. It started after we told the Plants to make sure they work the DVDs through letter automation and not the SPBS and FSM [flat sorting machine].” Tr. 4/178 (GFL28).

Although a number of factors appear to contribute to Netflix’s breakage rate, Netflix has concluded that the main cause of DVD damage is automated letter processing on the return trip. See Tr. 4/310 (GFL523) (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”); **[BEGIN PROPRIETARY]**

[END PROPRIETARY]

² The directive did not apply to return mailpieces (from customer to Netflix).

In November 2005, after a dinner meeting between the top managements of Netflix and the Postal Service, **[BEGIN PROPRIETARY]**

[END PROPRIETARY] at Netflix, sent **[BEGIN PROPRIETARY]**

[END PROPRIETARY] an email reiterating that “[c]urrently the only viable solution to scrap [i.e., DVD breakage] reduction is the culling of our returns prior to getting into the automation stream.” Tr. 4/376-76 (GFL1484-1485) (quoted in USPS response to GFL/USPS-103(b)); *see also* Tr. 4/522 (GFL73947)

[BEGIN PROPRIETARY]

[END

PROPRIETARY]

According to Netflix, the three most effective ways to reduce the damage rates are: **[BEGIN PROPRIETARY]**

[END PROPRIETARY] *See* Tr. 4/523 (GFL73948). Netflix’s belief is supported by testing performed by ATR, a consultant hired by Netflix to determine the causes of DVD breakage and recommend solutions to the problem. After extensive testing, ATR found that **[BEGIN PROPRIETARY]**

[END PROPRIETARY]

In this case, the Postal Service submitted testimony by Robert Lundahl, an engineer for ATR, that various design and manufacturing techniques researched by his company for Netflix can make DVDs more resistant to breakage in automated letter processing. On cross-examination, however, Mr. Lundahl conceded that full implementation of his techniques would not eliminate disk breakage, and Netflix's implementation of his techniques had reduced breakage by only one-third. It is telling that Netflix, even after adopting Mr. Lundahl's supposed fixes, still continues to monitor its disc breakage rates and send the Postal Service weekly report cards on its performance in this area. Glick Rebuttal (GFL-RT-1) at 13 (Tr. 11/1919, Tr. 12/2022); Tr. 7/1354 (Lundahl), Tr. 11/1974, 1976-1978 (Glick).

***Blockbuster experience.* [BEGIN PROPRIETARY]**

³ [END PROPRIETARY] The minutes from the Round-Trip Disc Mail (RDM) Work Group, dated September 26, 2005, summarize a teleconference with Blockbuster on September 23:

[Blockbuster] expressed concern about damage to the discs in the current Blockbuster design. He reported an overall damage rate of 3% with the newer envelope designs, with about a 2.8% rate for pieces mailed from the distribution centers compared with 5% for pieces mailed from the retail stores. We replied that mail from the retail stores goes through the culling operations twice, on the outbound and on the inbound. Mail presented from the distribution centers goes through those operations only once, on the inbound.

³ [BEGIN PROPRIETARY]

[END PROPRIETARY]

Tr. 4/356 (GFL771).

Like Netflix, Blockbuster has tried to reduce its DVD breakage rates by asking Postal Service field officials to cull DVD mailers for manual processing: **[BEGIN PROPRIETARY]**

[END PROPRIETARY] 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”).

GameFly experience. Since the beginning of GameFly’s operations, the company also has suffered breakage of its DVDs in the mail, particularly when enclosed in lightweight mailers without protective inserts. See Joint Statement ¶ 27. The breakage occurs primarily during the processing of return DVD mailers on Postal Service automated letter processing equipment. In fact, GameFly CEO Dave Hodess testified that the “first thing” GameFly employees told him about mail processing when he arrived at the company was “don’t let the DVDs go on letter machines because they break them.” Tr. 5/890. Mr. Hodess subsequently witnessed this destruction first hand during a trip to the Los Angeles P&DC in 2007. Tr. 5/890-891.

The Postal Service suggested that GameFly avoid automated letter processing equipment, including the automatic facer-canceller system (“AFCS”), by using mailers at

least 8.5” in height. Joint Statement ¶ 50. This would require the payment of postage for a two-ounce First-Class Mail flat. The Postal Service has acknowledged that an 8.5” tall mailpiece with sufficient stiffness not to fold over may well exceed one ounce. Joint Statement ¶ 52. In response to discovery, the Postal Service has also acknowledged that it has never studied the feasibility of producing such a mailer design. USPS response to GFL/USPS-57 (C217).

While not using an 8.5” tall mailpiece, GameFly has, consistent with the Postal Service’s suggestion, been able to generally avoid the automated letter processing of its pieces by mailing them as two-ounce flats with warnings such as “FIRST-CLASS MAIL FLAT” and “PROCESS ON AFSM-100.” The avoidance of automated letter processing equipment has come at a postage cost of \$2.10 per round trip. Joint Statement ¶¶ 41, 48, 91.

USPS witness Lundahl, whose testimony is summarized on pp. 14-15, *supra*, also testified that the same design fixes adopted by Netflix could, if adopted by GameFly, make its DVDs more resistant to breakage in automated letter processing. As noted above, Mr. Lundahl conceded on cross-examination that implementation of his techniques reduced disk breakage rates by only one-third. Glick Rebuttal (GFL-RT-1) at 13 (Tr. 11/1919, Tr. 12/2022); Tr. 7/1354 (Lundahl), Tr. 11/1974, 1976-1978 (Glick). For a DVD rental company whose mailers were processed primarily on letter automation, the net DVD breakage rate after application of Mr. Lundahl’s techniques likely would still be “very high.” Tr. 11/1969 (Glick cross-ex). Moreover, most of the fixes involve manufacturing process or design changes that no DVD rental company

other than Netflix—and certainly not GameFly—has the size and buying power to force DVD manufacturers to adopt. Tr. 6/1185 (Hodess); Tr. 11/1974-1977 (Glick).

2. Jamming of Postal Service equipment

Many DVD mailers—particularly those used by Netflix—have a second operational problem: they tend to jam Postal Service letter processing equipment. Although the Netflix DVD mailer design apparently satisfies the DMM standard for machinability (essentially a static deflection test, *see* DMM 101.1.2.e), the tendency of the Netflix mailer design to jam the Postal Service’s automated letter processing equipment in actual operation has been apparent since 2002. Thus, while Netflix’s mailer design may be nominally machinable, it is effectively nonmachinable. Tr. 11/1993-95 (Glick).

In 2002, when Netflix submitted its DVD mailer design to Postal Service engineering personnel for testing, the Engineering Department, after testing samples of the design, found that it was “not automation compatible” because of its poor performance in return mailings. Moreover, the engineering report failed to find that the return mailer was even machinable. Tr. 4/302 (GFL512). Subsequent reports of the Postal Service’s Engineering Department have repeatedly found that that the design is processed with “very poor results” because of its tendency to “cause jams and be mis-sorted during processing.” Glick Rebuttal (GFL-RT-1) at 22-23 (Tr. 11/1928-1929, 12/2031-2032) (citing Postal Service documents).⁴

⁴ The poor performance of the Netflix mailer design appears to have several causes. **[BEGIN PROPRIETARY]**

The tendency of the Netflix mailer to jam Postal Service equipment was also noted in the Christensen Associates reports of August and November 2006; the Postal Service site personnel whom Christensen Associates interviewed; the November 2007 OIG report; and in Standard Operating Procedures and other directives issued by Postal Service Area, District and P&DC officials. Glick Rebuttal (GFL-RT-1) at 21-27 (Tr. 11/1927-1933, Tr. 12/2030-2036) (citing and quoting GFL374, 520, 521, 527-528, 536, 685, 690, 692, 695-96, 928, 929, 935, 936, 1025, 1029, 1030, 7287, 7293, 7295, 7298-7299 (C127-128); Tr. 4/142). Likewise, the November 2007 report of the OIG recommended that (1) the machinability standards in the DMM be revised to include the ability of a mailpiece to withstand automated letter processing without damage, and (2) DVD mailers that do not satisfy the revised standards be assessed a nonmachinable surcharge. Tr. 5/282-284 (GFL445-447).

Internal communications by Postal Service personnel further confirm the inability of the Netflix mailpiece design to withstand high speed automated letter processing without jams or DVD damage. *See, e.g.*, Tr. 4/173-74 (GFL22-23) (email from **[BEGIN PROPRIETARY]** **[END PROPRIETARY]** dated March 25, 2002) ("This CD is not, repeat not machineable mail"); Tr. 4/160 (GFL6) (email from **[BEGIN PROPRIETARY]** **[END PROPRIETARY]** dated Sept. 22, 2003) ("Wow, that is interesting. . . . [W]e even sent a letter telling them [Netflix] they don't have to pay the [non-automation] surcharge. I wouldn't have liked to be at the tests they

[END PROPRIETARY] *see also* Tr. 4/310-312 (GFL523-525) (memorandum from **[BEGIN PROPRIETARY]** **[END PROPRIETARY]** identifying breakage and other machinability problems in 2006 with two-way DVD mailers used by Netflix and Blockbuster).

conducted to justify that exception.”); Tr. 4/161 (GFL7) (letter from **[BEGIN PROPRIETARY]** **[END PROPRIETARY]** dated September 23, 2003) (“the clerks/mailhandlers we talked to all said that they thought the [Netflix] mail piece was nonmachinable because of the rigid DVD disc contained in the envelope”); **[BEGIN PROPRIETARY]**

[END PROPRIETARY] Tr. 4/313-20 (GFL527-34) (Pacific Area DVD Standard Operating Procedures (“SOP”) issued March 1, 2005) (“The incoming Netflix piece . . . is **not automation compatible**.”) (emphasis in original). *See also* Tr. 4/641 (GFL81093) (December 20, 2005 email from an employee in Santa Ana to an official in the PCSC) (emphasis added):

[BEGIN PROPRIETARY]

[END PROPRIETARY]

See also Tr. 4/214 (GFL126) (statement of USPS Return Disc Mail workgroup) (“Currently, the design of returning Netflix disks is nonmachinable.”); USPS response to GFL/USPS-126 (identifying authors of GFL126) (C248); **[BEGIN PROPRIETARY]**

[END PROPRIETARY]

C. The Postal Service Gives The Vast Majority Of Netflix Return Mailers Manual Culling And Special Manual Processing At No Extra Charge, While Refusing To Offer Similar Terms Of Service To GameFly And Other DVD Rental Companies.

The logical and nondiscriminatory remedy for the problems of DVD breakage and jamming would be the establishment of operational and pricing requirements applicable to all DVD rental companies. Instead, the Postal Service has established a tacit caste system among DVD rental companies:

- (1) The Postal Service has given Netflix (and, to a lesser extent, Blockbuster) a host of preferences in processing—including diversion from the automation letter stream, hand-culling, and hand processing—at no extra cost. The Postal Service has refused to offer the same arrangement to other DVD rental companies, including GameFly.
- (2) The Postal Service also has allowed Netflix to pay postage for its DVD mailers at machinable letter rates, while defining similar or

identical mailpiece designs as nonmachinable. GameFly has managed to avoid automated letter processing of DVD return mailers only through the costly workaround of entering its DVDs as two-ounce flats. The result is that GameFly must pay flats rates—and the second ounce charge—just to achieve the bypass of automated letter processing that Netflix enjoys by paying only a one-ounce letter rate.

We discuss the discriminatory provision of manual processing in this subsection, and the discriminatory classification of mailer designs as machinable or nonmachinable in subsection D.

1. Netflix

The Postal Service provides special custom handling to the overwhelming majority of Netflix return DVD mailers, despite charging letter rates of postage (typically one-ounce letter rates) without a nonmachinable surcharge. See Joint Statement ¶ 79. This preferential treatment includes multiple upgrades from ordinary processing, including: **[BEGIN PROPRIETARY]**

[END PROPRIETARY] Glick Rebuttal (GFL-RT-1) at 7 (Table 1) and App. A, Table A-2 (Tr. 12/2016 and 2043); Tr. 4/653-654 (Glick cross-ex testimony summarizing review of USPS directives re processing of Netflix mailers); Tr. 4/374

(GFL1364) (LSS Project Background Information July 2009)). See also Tr. 4/159 (GFL4), Tr. 4/162-163 (GFL8-9), Tr. 4/179 (GFL29), Tr. 4/180 (GFL30), Tr. 4/181 (GFL33), Tr. 4/202 (GFL101), Tr. 4/237 (GFL272), Tr. 4/279 (GFL428), Tr. 4/285 (GFL458), Tr. 300 (GFL509), Tr. 4/313-20 (GFL527-534), Tr. 4/365 (GFL934), Tr. 4/374 (GFL1364), Tr. 4/375-76 (GFL1484-1485), Tr. 4/535-36 (GFL73959-61); USPS response to GFL/USPS-121 (C243-244).⁵

The special custom handling provided to Netflix returns has been well-documented. According to a 2006 report by Christensen Associates, **[BEGIN PROPRIETARY]**

[END

PROPRIETARY] Christensen Associates also reported that 77 percent of Netflix return volume received manual processing in Fiscal Year 2005. GFL1036 (C99); Tr. 4/366 (GFL1037).

One year later, the November 2007 OIG report found that 70 percent of the two-way DVD mailers from Netflix still received manual processing because of the high breakage rates of DVDs on automated mail processing equipment. USPS Office of Inspector General, Audit Report No. MS-AR-08-001, *Review of Postal Service First-*

⁵ During cross-examination of Mr. Glick, the Postal Service questioned him about the precise definition of manual processing. As Mr. Glick explained, the common denominator of manual processing is human intervention that avoids automated processing, which breaks disks. See Tr. 11/1978-83, 12/2051-2052. The particular methods of manual processing at issue here are listed in Glick Rebuttal (GFL-RT-1) at 7 (Table 1) and App. A, Table A-2 (Tr. 12/2016 and 2043).

Class Permit Reply Mail (November 8, 2007) (“OIG Report”) (C2-21); Joint Statement ¶ 84 (identifying the customer as Netflix).

The Postal Service’s practice of giving manual processing to DVDs from Netflix has continued since the OIG Report. Joint Statement ¶ 87; Tr. 4/370 (GFL1335). “Headquarters officials of the Postal Service have been aware that the manual culling and processing of Netflix return DVD mailers has often occurred since November 2007.” Joint Statement ¶ 90. In fact, 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) (C199 and C200). Postal Service witnesses reconfirmed this fact last month during hearings in this case. Tr. 10/1804 (Seanor); Tr. 10/1875-1876 (Barranca).⁶

The special custom handling given to Netflix has been implemented through SOPs and directives issued by multiple layers of Postal Service management, from headquarters officials to field offices throughout the United States. Tr. 4/165-171, 245-46, 256-57, 287, 298-99, 313-20, 319-38, 344-45, 346, 382, 534, 536, 584, 587-88 (GFL12-GFL18, GFL302-GFL303, GFL347-348, GFL462, GFL495-496, GFL527-

⁶ The evidentiary value of Mr. Barranca’s prefiled testimony (USPS-T-1; C129-165) is virtually nil. While labeled testimony, it is in substance a trial brief. It appears to have been written by the Postal Service’s attorneys, and does not appear to be based on any personal knowledge of the facts by Mr. Barranca. See Tr. 10/1852-54, 1856-63 (indicating that he based his testimony on little more than a review of testimony, pleadings and other case documents and “conversations with Postal Service counsel”) (C129-165); Tr. 10/1866-72, 1876 (unable to identify the documents supposedly supporting several of his claims). Moreover, while the testimony asserted that GameFly “cherry-picked” or miscited documents obtained from the Postal Service in discovery, Mr. Barranca offered no analysis of most of the documents that GameFly cites. And Mr. Barranca’s testimony did not even attempt to discuss the most important documents in the case—the Christensen Associates study, the OIG report, and the subsequent admissions by the Postal Service about the continuing special treatment given to Netflix since 2007.

GFL534, GFL533-GFL551, GFL558-GFL559, GFL562, GFL2422, GFL73959, GFL73961; GFL80729; GFL80749-80750).

The most explicit and detailed directives typically have been issued by Area offices. In 2005, for example, Standard Operating Procedure (“SOP”) directives issued by the Pacific and Eastern Areas required field personnel to manually cull Netflix reply mailers, place them into special trays, and stack the trays into dedicated mail containers for “direct dispatch to the processing and distributing facility serving the closest Netflix processing center.” Tr. 4/313-20 (Pacific Area SOP (March 1, 2005)) (GFL527-534); Tr. 4/321-28 (Eastern Area SOP (March 3, 2005)) (GFL535-542). Even though the Pacific Area SOP was rescinded, processing of Netflix continues to be substantially similar to that set forth in the SOP. See USPS Response to GFL/USPS-106(d) (reproduced at end of Tr. vol. 10) (C241).⁷

In addition, many Processing & Distribution Centers (“P&DC’s”) and Districts have published standardized procedures for handling Netflix mailpieces. For example, the Dallas P&DC issued an SOP on December 31, 2003, directing that:

⁷ During the hearing on October 14, 2010, the Postal Service asserted that the Eastern Area SOP has never been formally promulgated by the Postal Service. Tr. 10/1783, 1831, 1846. This astonishing claim, even if true, would be immaterial. The Postal Service has confirmed that, whether or not the Pacific Area SOP was formally rescinded or the Eastern Area SOP was formally issued, “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.” USPS Response to GFL/USPS-106(c) (C241-242); Tr. 9/1653, 1708. Additionally, the Christensen study and the Office of Inspector General Report confirmed this statement with detailed findings that the Postal Service processed Netflix mail substantially as described in the Eastern Area SOP. Thus, the thrust of the Eastern Area SOP is consistent with the overwhelming weight of the other evidence in this case.

NETFLIX pieces should be captured in the 010 culling unit, at the AFCS machines, and at the FIM DBCS machine. Pieces should be collected and placed in letter trays in U-Carts labeled for NETFLIX. There is a tray for NETFLIX Houston and a tray for NETFLIX Coppell. Pieces should be placed in correct trays. Trays should be labeled with the labels at the NETFLIX U-Carts and dispatched to NTX P&DC and to Houston P&DC.

Tr. 4/346-47 (GFL562-563). *See also* Alabama District (Tr. 4/587) (GFL80749); (GFL80761); **[BEGIN PROPRIETARY]**

[END

PROPRIETARY] Anchorage City Post Office (Tr. 4/603) (GFL80859); Atlanta P&DC Service Bulletin (August 4, 2003) (Tr. 4/245) (GFL302); Austin P&DC (Tr. 4/607) (GFL80866) (first three bullet points); Columbus P&DC (Tr. 4/608-09) (GFL80873-80874); Fort Worth District SOP (May 13, 2005) (Tr. 4/344) (GFL558); Houston P&DC and North Houston P&DC (Tr. 4/604, 611, 612) (GFL 80861, 80883, 80884); Jackson MS P&DC (Tr. 4/613) (GFL80889); Jacksonville P&DC (Tr. 4/634-36) (GFL81009-81011) **[BEGIN PROPRIETARY]**

[END PROPRIETARY]

Kansas City P&DC (Tr. 4/602) (GFL80855); Rochester P&DC (Tr. 4/610) (GFL80875); Salt Lake District SOP (April 11, 2008) (Tr. 4/348-50) (GFL564-566); South Florida District (Tr. 4/593, 594) (GFL80775, 80782); Tampa P&DC (Tr. 4/614) (GFL80934); Topeka P&DC (Tr. 4/601) (GFL80853); Tr. 10/1829-30 (Seanor).

Other P&DC's have reported that Netflix return DVDs are regularly culled to avoid automation processing. *See* USPS Response to GFL/USPS-104 (all districts in

Pacific Area process Netflix mail as described in Pacific Area SOP) (C240); **[BEGIN PROPRIETARY]**

[END PROPRIETARY] Tr. 4/595-99 (GFL80789-91, 80809-80810) (North Metro P&DC); Tr. 4/583 (GFL80728) (San Diego); Tr. 4/181-84 (GFL33-36) (Suburban Maryland P&DC) **[BEGIN PROPRIETARY]**

[END PROPRIETARY] Tr. 4/605-06 (GFL80863-64) (P&DCs in Western Area).

The extent of manual processing quickly became so widespread that, as early as July 2003, two Postal Service operations officials in Chicago commented that “it seems almost everyone [in San Jose and elsewhere] is processing this mail [Netflix DVD mailers] manually Netflix got a sweet deal from our marketing department. Netflix is getting an automation mail rate discount for pieces that we process manually!” Tr. 4/279 (GFL428).

Likewise, on May 16, 2005, a Postal Service operating or engineering employee reported that:

Currently, DVDs being returned to Netflix jam excessively in letter automation so *plants try to pull them out before the AFCS and process them manually*. This prevents significant DVD cracking that would occur as disks are repetitively bent through gates on our equipment, but *it is very costly for us*.

Tr. 4/180 (GFL30) (emphasis added). *See also* Tr. 4/159 (GFL4) (reporting “Many sites reporting problems” and “handling the return mailers manually (culling from AFCS)”); Tr. 4/179 (GFL29) (“To properly handle the CD/DVD mail, facilities generally remove such mail pieces before AFCS and DBCS processing and route them to manual sortation or to the flat operations for processing on the AFSM 100 machines.”).

Presiding Officer’s Ruling No. C2009/1-5 (issued Sept. 28, 2009) directed 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.” *Id.* at 19. Rather than comply with this order, the Postal Service has stipulated to the existence of these items. USPS Status Memorandum (Feb. 8, 2010) at A-2 (discussing GFL/USPS-31).

Netflix pays neither flats prices nor a nonmachinable surcharge nor a second-ounce charge. As a result, the postage per piece incurred by Netflix for Permit Reply Mail is less than half the two-ounce flats postage incurred by GameFly (\$1.05 as compared to \$0.44). Joint Statement ¶ 91.⁸

2. Other DVD rental companies

The Postal Service has refused to offer smaller DVD rental companies Netflix levels of manual processing of their DVD return mailers when entered as letter mail. In November 2006, for example, Christensen Associates estimated to the Postal Service that 77 percent of Netflix return volume, but less than 35 percent of Blockbuster return

⁸ As GameFly witness Sander Glick explained in his direct testimony (GFL-T-1), Netflix actually pays less than \$0.44 per piece because of presort discounts on its outbound mailings. GameFly does not challenge the appropriateness of the presort discounts.

volume, received manual processing. GFL1036 (C99); Tr. 4/366 (GFL1037); *see also* GFL691-92 (OIG Report at 5-6) (C8-9). Postal Service witness Seanor confirmed during cross examination that (1) Netflix is the primary recipient of manual processing; (2) Blockbuster mailers are sometimes culled at the same time, and (3) the Postal service does not regularly manually cull the mailers of other DVD rental companies. Tr. 10/1821. The Postal Service's refusal to offer Netflix-like service to other DVD rental companies has forced them to choose between adopting costly workarounds or accepting higher rates of DVD breakage. Tr. 3/107-108 (Glick cross-ex).

As a result, smaller DVD rental companies must choose between paying higher postage (e.g., GameFly) or accepting more processing on letter automation (e.g., Blockbuster). For example, the average postage per piece for outbound DVD mailpieces in Fiscal Year 2008 for Netflix was **[BEGIN PROPRIETARY]**

⁹ **[END PROPRIETARY]**

a. Blockbuster

A significant share of Blockbuster's inbound DVD mail volume receives culling and manual processing, although the percentage is lower than for Netflix. Joint Statement ¶ 107; *see e.g.*, **[BEGIN PROPRIETARY]**

⁹ As noted above, the presort discounts received by Netflix and Blockbuster—but not GameFly—on outbound mailings account for a small part of these rate differentials. Glick Direct (GFL-T-1) at 3 & 4 (Tr. 4/139-40).

[END

PROPRIETARY] Tr. 4/366 (GFL1037) (November 2006 Christensen Associates report); Tr. 10/1821 (Seanor).

Blockbuster has made repeated requests to receive manual processing on a higher percentage of its return DVD mailers. On or about February 23, 2006, for example, 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.” Joint Statement ¶ 102. Blockbuster also requested in subsequent communications that its return pieces not receive automated processing. Joint Statement ¶ 103. When Postal Service officials balked at Blockbuster’s request, Blockbuster escalated the issue to Postal Service headquarters. Tr. 4/247 (GFL311); Tr. 4/248-50 (GFL315-317); Tr. 4/255 (GFL340); USPS responses to GFL/USPS-132 to 134 (C250-253).

The Postal Service denied Blockbuster’s request, supposedly on the ground that processing decisions of this kind were made by field officials, not headquarters:

“We believe it important to leave [the degree of manual processing] to the discretion of local operations management to carry out the most productive processes based on local circumstances.

Tr. 4/258 (GFL349) (USPS letter to Blockbuster dated June 29, 2007); accord, Tr. 4/254 (GFL337) (email to Blockbuster); *see also* Tr. 4/248 (GFL 315) (internal USPS email dated June 11, 2007) (“They [Blockbuster] have been told previously it was up to each local plant to make this decision.”). Blockbuster apparently accepted this explanation.

See Tr. 4/256 (GFL347) (internal USPS email dated Sept. 12, 2007) (“I spoke with **[BEGIN PROPRIETARY]** **[END PROPRIETARY]** for Blockbuster] and described the reasons why we were not going to take plant processing discretion out of the equation, and it seemed to work. BB [Blockbuster] has been silent since, as far as I know.”).

Contemporaneous internal correspondence indicates, however, that the excuses offered by the Postal Service were pretexts. In fact, Postal Service headquarters avoided codifying the special treatment received by Netflix in a national SOP precisely for the purpose of concealing from Blockbuster and smaller DVD rental companies the extent of the preference given to Netflix, and thereby to minimize the risk that Blockbuster or another DVD rental company might seek similar treatment or file a discrimination complaint. See Tr. 4/256-67 (GFL347-348) (internal USPS email correspondence) (“As I know you know, any national codification of Pacific’s SOP will certainly be met with [Blockbuster’s] insistence on equal treatment.”). See also Tr. 4/158 (GFL1) (email dated September 6, 2005) (noting that this discrimination could lead to the filing of a complaint); Tr. 4/247 (GFL311) (email dated Feb. 22, 2006) (“We knew that culling Netflix at the AFCS was going to open the door to other mailers requesting the same treatment.”); Tr. 4/250 (GFL315-316) (2007 email thread re Blockbuster request for headquarters directive calling for culling of Blockbuster mailers from AFCS operations); Tr. 4/250 (GFL317) (Blockbuster letter); Tr. 4/251-53 (GFL327-329) (internal USPS discussion re same); Tr. 4/254 (GFL337) (noting denial of Blockbuster request); Tr. 4/255 (GFL340); Tr. 4/356 (GFL771) (notes of Postal Service/Blockbuster teleconference in which Blockbuster complained about DVD breakage rates as high as five percent).

b. GameFly

The Postal Service has treated GameFly even more poorly than Blockbuster. The Postal Service has never offered GameFly the option of entering its DVDs in lightweight mailers like those of Netflix, at the rates of postage charged for machinable letters, while receiving the same degree of diversion from automated letter processing that Netflix receives. USPS Responses to GFL/USPS-60 and 61 (C219 and C220); Tr. 5/888, 895-97 (Hodess cross-ex); Glick Rebuttal (GFL-RT-1) at 14-16 (Tr. 11/1920-1922, 12/2023-2025).

Unable to obtain Netflix-level manual processing of DVD return mailers entered at letter rates, GameFly has resorted to the least bad alternative: paying extra for its DVD mailers to be processed as flats. Joint Statement ¶¶ 41 & 48. As a result, GameFly pays **[BEGIN PROPRIETARY]** **[END PROPRIETARY]** more in postage than Netflix does for an average round trip DVD mailing, even though the difference in average cost is at most **[BEGIN PROPRIETARY]** **[END PROPRIETARY]** Joint Statement ¶¶ 82, 91; Glick Direct (GFL-T-1) at 1-2 (Tr. 4/137-38).¹⁰

¹⁰ **[BEGIN PROPRIETARY]**

[END PROPRIETARY] Third, the Christensen study used the Postal Service's lower estimates of the variability of mail processing costs. Using the higher variabilities accepted by the Commission in past omnibus rate cases and post-PAEA annual compliance reviews would increase the estimated cost of the Netflix return process above that estimated by Christensen. Glick Rebuttal (GFL-RT-1) at 8-9 (Tr. 11/1914-1915, 12/2017-2018). See also Tr. 4/664 (Glick cross-ex) **[BEGIN PROPRIETARY]**

[END PROPRIETARY] Further, much of the cost difference

Before the filing of this Complaint, GameFly spent 18 months in time-consuming but ultimately fruitless negotiations with the Postal Service in an effort to obtain relief without litigation.

- On October 4, 2007, GameFly met in L'Enfant Plaza with representatives of the Postal Service's Operations, Engineering and Mailing Standards groups, and met separately with the Office of Inspector General. On December 19, 2007, GameFly had multiple meetings in L'Enfant Plaza with representatives of the Postal Service's Operations, Engineering, Mailing Standards and Pricing Groups. Joint Statement ¶¶ 113-115.
- In December 2007, GameFly and Postal Service Engineering tested a variety of alternative mailer configurations at the USPS facility in Merrifield, Virginia, in an effort to design a mail piece that would be mechanically culled by USPS equipment out of the letter mailstream and into the flats mailstream. Further tests were performed in April 2008, with Postal Service Engineering and GameFly participating. On September 10, 2008, GameFly had separate meetings in L'Enfant Plaza with the representatives of the Postal Service Operations, Engineering and Mailing Standards groups, and with the Pricing group. Joint Statement ¶¶ 116-118.

between Netflix and GameFly pieces is on the outbound leg because outbound Netflix pieces are presorted, and outbound GameFly pieces are not. But Netflix receives worksharing discounts for the presorting, a rate benefit that GameFly does not challenge. *See also* Response to PR/USPS-T1-1(c) (C191-192); Glick Direct (GFL-T-1) at 4-7 (Tr. 4/140-143); Glick Rebuttal (GFL-RT-1) at 21, fn. 15 (Tr. 11/1927, 12/2030); Tr. 10/1797-1798 (Seanor) (noting tendency of Netflix return pieces to jam, and effect of jamming on productivity).

- From July 2007 to July 2008, GameFly performed “live mail” tests of multiple mailer configurations. These tests were performed without the involvement of Postal Service Engineering. Joint Statement ¶ 119.
- In December 2008, GameFly requested, as an interim remedy, that the Postal Service waive the additional ounce rate for GameFly pieces as part of the general price changes that were ultimately approved in Docket No. R2009-2 and implemented by the Postal Service in May 2009. Joint Statement ¶ 121. The Postal Service declined, however, to include any of the pricing and classification proposals suggested by GameFly in the price and classification changes filed by the Postal Service with the Commission in May 2008 in Docket No. R2008-1, in May 2009 in Docket No. R2009-2, or in any other docket. Joint Statement ¶ 122.
- Beginning in January 2009, as the likelihood of litigation became increasingly apparent, counsel for GameFly and counsel for the Postal Service engaged in email and telephone exchanges to discuss GameFly’s concerns in an attempt to avoid the filing of a complaint. Joint Statement ¶ 126. These communications also were unsuccessful.
- On March 23, 2009, GameFly counsel and Daniel J. Foucheaux, Jr., Chief Counsel, Pricing and Product, for the Postal Service, discussed this matter by telephone. Gamefly sent an email to Mr. Foucheaux requesting a meeting by April 22, 2009 to resolve or settle the issues stated in this complaint. A draft of GameFly’s Complaint was attached to the email. Paragraphs 2, 34-40 and 47 of the draft complaint stated that, unless GameFly’s grievances were

resolved, GameFly intended to challenge as unduly discriminatory the Postal Service's practice of offering Netflix and Blockbuster, but not GameFly, manual culling and processing DVD mailers entered at letter rates. Joint Statement ¶ 127.

- On March 26, 2009, Gamefly sent an email to Mr. Foucheaux notifying him it was going to file a letter with Mary Anne Gibbons, General Counsel of the Postal Service, in conformance with the complaint rules that had been recently promulgated in Docket No. RM2008-3. In an email response, Mr. Foucheaux confirmed receipt of this email on March 26, 2009, and also stated that "There is some movement internally (a meeting has been scheduled). I have no idea where it will go, but it could lead to something." The Postal Service did not further respond to the email. Joint Statement ¶ 128.
- Also on March 26, 2009, GameFly sent a letter to Mary Anne Gibbons, the Postal Service's General Counsel, requesting a meeting by April 22, 2009 to resolve or settle the issues stated in GameFly's draft Complaint. The letter stated that the complaint would be filed on April 23, 2009 unless the Postal Service submitted to GameFly by April 22 a "concrete proposal for processing GameFly DVDs on terms and conditions offered to two large DVD mailers, Netflix and Blockbuster." A draft of the Complaint was attached to the letter. Paragraphs 2, 35-39, 41 and 47 of the draft complaint stated that, unless GameFly's grievances were resolved, GameFly intended to challenge as unduly discriminatory the Postal Service's practice of offering Netflix and

Blockbuster, but not GameFly, manual culling and processing DVD mailers entered at letter rates. Joint Statement ¶ 129.

- Neither Ms. Gibbons nor any other employee of the Postal Service submitted the proposal requested by GameFly, or otherwise responded to the March 26 letter, by the close of business on April 22, 2009. GameFly filed its Complaint on the following day, April 23, 2009. Joint Statement ¶ 130-131.
- The negotiations continued after the filing of the complaint as well. During the negotiations, GameFly asked the Postal Service to offer a reduced rate for round-trip DVD mailers, or a niche classification that would avoid the need to pay a two-ounce flats rate for qualifying DVD mailers. Joint Statement ¶ 120. The Postal Service turned down GameFly's proposals without making any counteroffer.

On May 17, 2010, Andrew German, a Postal Service attorney, sent GameFly counsel a letter purportedly offering GameFly service on the same terms as Netflix. Tr. 5/950-51 (German letter). The Postal Service introduced the letter shortly afterwards in cross-examining GameFly witness Hodess (Tr. 5/944-955), and Postal Service witnesses seized upon the letter in their July testimony as an offer that had eliminated any discrimination between Netflix and GameFly. Barranca (USPS-T-1) at 31-32 (C164-165); USPS-T-3 (Seanor) at 21 (C189).

This claim is nonsensical. First, the offer does not include any commitment that GameFly would actually receive the same avoidance of automated letter processing as Netflix—or satisfy any particular quantitative benchmark at all. Tr. 4/654-5 (Glick); Tr.

5/897-900, 948, 954-5 (Hodess cross-ex); Glick Rebuttal (GFL-RT-1) at 14 (Tr. 11/1921, 12/2024); Tr. 11/1960-1961, 1964 (Glick cross-ex).

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. German Letter at 1 (Tr. 5/950); Tr. 5/899 (Hodess); Glick Rebuttal (GFL-RT-1) at 15 (Tr. 11/1921, 12/2024). The absence of any commitment to a quantitative benchmark is a crucial omission, because 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-by-Mail, Survey Instruments, Methodologies, and Results, Christensen Associates, November 2006 (GFL1036) (C99).
- "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) (C9).¹¹

- 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.

See *also* Glick Rebuttal (GFL-RT-1) at 15 (Tr. 11/1921, 12/2024).

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. As Mr. Glick noted:

Netflix can look at history, and history says very clearly that the Postal Service is going to cull the vast majority of Netflix pieces.

If GameFly looks at history, what does it show? It shows that the Postal Service does not do the same for other mailers of letter-shaped DVD mail pieces. That’s what the record shows. So for GameFly to get the same processing as Netflix there needs to be a a commitment on behalf of the Postal Service, and there is no commitment in the [German] letter.

Tr. 11/1960-61 (Glick cross-ex).

¹¹ The DVD rental company whose return mailpieces received the most manual processing was Netflix. Joint Statement of Undisputed and Disputed Facts (July 20, 2009), ¶ 84.

Even USPS witness Seanor acknowledges that a formal directive is probably necessary to ensure the same level of culling for GameFly pieces. Tr. 10/1811, 1814, 1818-9 (Seanor); Glick Rebuttal (GFL-RT-1) at 15 (Tr. 11/1921, 12/2024).¹² And the Postal Service has made essentially the same admission in response to GameFly interrogatory GFL/USPS-63 (C221). The interrogatory asked whether the Postal Service would “offer to GameFly the same degree of manual culling and priority manual processing that the Postal Service currently provides to Netflix.” The Postal Service declined to do so, stating instead that the level of manual culling received by GameFly DVD mailers would be left to the “discretion” of “field officials.” USPS Response to GFL/USPS-63 (C221). This, of course, is the very arrangement that has produced the current discrimination against GameFly.

Moreover, 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 has conditioned its offer 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.

The Postal Service asserts that these conditions are reasonable. Seanor (USPS-T-3) at 21 (C189). In fact, they are merely pretexts, for neither the number of pickup points

¹² Seanor stated that the instruction would not need to come from Headquarters, but to achieve Netflix-like processing, clearly would require a nationwide commitment.

nor the depth of entry into the postal system have a significant effect on the Postal Service's costs. Tr. 11/1963-64 (Glick).

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 (Seanor); Glick Rebuttal (GFL-RT-1) at 17-18 (Tr. 11/1923-1924, 12/2026-2027); Tr. 11/1963-64 (Glick cross-ex). 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." Glick Rebuttal (GFL-RT-1) at 18 (Tr. 11/1924, 12/2027).

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. Belair (USPS-T-2) at 3 (Tr. 9/1595); Seanor (USPS-T-3) at 1 (C169). 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. Glick Rebuttal (GFL-RT-1) at 18 (Tr. 11/1924, 12/2027).

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. *Id.* at 18-19 (Tr. 11/1924-1925, 12/2027-2028). A September 12, 2002, letter from **[BEGIN PROPRIETARY]** **[END PROPRIETARY]** 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." Tr. 4/164 (GFL10). Yet, manual processing of Netflix mail was being reported around this time or shortly thereafter. See Tr. 4/159 (GFL4) (timeline noting that by June 24, 2002, many USPS sites were "handling [Netflix] return mailers manually (culling from AFCS)"); Tr. 4/161-63 (GFL7-9) (detailing manual processing by September 2003 even though the plants in question were not receiving large volumes of Netflix mail); Tr. 4/183 (GFL35) **[BEGIN USPS PROPRIETARY]**

[END USPS PROPRIETARY]; Tr. 4/279 (GFL428) (July 17, 2003 email reading, "It seems almost everyone is processing this [Netflix] mail manually.")

c. Smaller DVD rental companies

In addition to Blockbuster and GameFly, a smaller DVD rental company named **[BEGIN PROPRIETARY]** **[END PROPRIETARY]** requested manual processing of its inbound DVD mailers. The Postal Service denied this request. USPS Response to GFL/USPS-193 (260).

D. The Postal Service Accepts The Netflix Reply Mailer Without Charging A Nonmachinable Surcharge, But Classifies The Similar Or Identical Mailer Designs Of Other Companies As Nonmachinable.

To compound the disparity in treatment, the Postal Service accepts Netflix DVD mailers without charging a nonmachinable surcharge even though the mailer design is effectively nonmachinable, yet has ruled repeatedly that similar or identical mailer designs submitted by other companies for review are nonmachinable.

1. Netflix

Notwithstanding the effectively nonmachinable nature of Netflix DVD mailers, the Postal Service ruled in 2002 that the Netflix design was machinable. This ruling was made by the Postal Service's marketing department, against the judgment of the Postal Service engineers who tested the design. Joint Statement ¶ 77; Tr. 4/272-78, 302, 303 (GFL419-425, 512, 514); USPS response to GFL/USPS-1(b) and Exh. GFL/USPS-1A (C193-195). As one frustrated headquarters employee observed later:

[BEGIN PROPRIETARY]

[END PROPRIETARY] And because it was indiscriminately rolled out, Netflix was allowed to give us a mailer that isn't automation compatible and by one estimate costs the USPS \$75K a day.

Tr. 4/576 (GFL80128) (email from **[BEGIN PROPRIETARY]**

[END PROPRIETARY] dated January 4, 2005) (emphasis added).

In November 2007, the OIG found that the Postal Service's Marketing Department had made the 2002 determination on machinability without performing

testing on the Netflix mailpiece. Tr. 4/281 (GFL444). The OIG Report also indicated that the intervention of the Postal Service's marketing department into the decision-making process was procedurally irregular: under DMM 201.3.11.2, responsibility for advising mailers of the findings of flexibility tests rests with the Engineering, not Marketing. Tr. 4/281 (GFL444). The November 2007 report of the OIG recommended that (1) the machinability standards in the DMM be revised to include the ability of a mailpiece to withstand automated letter processing without damage, and (2) DVD mailers that do not satisfy the revised standards be assessed a nonmachinability surcharge. Tr. 4/282-84 (GFL445-447).

Since November 2007, however, the Postal Service has neither rescinded its June 24, 2002 decision approving the Netflix mailer nor taken any other action to implement the OIG recommendations. Tr. 10/1883-1886 (colloquy between Commissioner Blair and USPS witness Barranca). Thus, the Postal Service's "self-imposed wound" continues to fester. Tr. 11/1940, 1949 (Glick).

2. Other companies' mailer designs

The Postal Service has, however, repeatedly found nonmachinable DVD mailpiece designs submitted for approval by *other* companies. See Tr. 4/262-64, 276-77, 478-79, 481-84, 651 (GFL373-374, 7278-7279, 7285-7287, 7292-7295, 81118); USPS response to GFL/USPS-122 (C245-246); Tr. 4/640 (GFL81091) (November 30, 2005 email thread about a small DVD rental company that was "interested in doing the same thing as Netflix"; a PCSC official responded, "Aren't we supposed to not approve any new customers."). See also Tr. 4/639 (GFL81089) (email dated November 30, 2005, from USPS employee in Santa Ana):

[BEGIN PROPRIETARY]

[END PROPRIETARY]

[BEGIN PROPRIETARY]

¹³ **[END**

PROPRIETARY]

Since 2007, Postal Service Engineering has concluded that seven two-way DVD mailers submitted by several companies other than Netflix were operationally nonmachinable. These mailers were of similar size, weight, and construction to the Netflix two-way DVD mailer determined by Postal Service Mailing Standards in 2002 to be machinable. Joint Statement ¶ 92.

¹³ **[BEGIN PROPRIETARY]**

[END PROPRIETARY]

[BEGIN PROPRIETARY]

[END PROPRIETARY]

In November 2007, the OIG laconically observed that the Postal Service's inconsistent findings that the Netflix DVD mailpiece was machinable—but similar or “identical” mailpieces submitted by other companies were nonmachinable—“may lead mailers to perceive that the Postal Service shows favoritism toward some DVD rental services companies.” Tr. 4/282 (GFL 445).

E. The Postal Service Has Shrunk From Eliminating The Special Treatment Given To Netflix.

The favoritism shown Netflix has not gone unnoticed within the Postal Service. Many knowledgeable employees have worried about the Postal Service's disparate treatment of Netflix and other DVD rental companies, in terms of both the availability of

manual processing and the application of nonmachinable surcharges. But key headquarters officials, unwilling either to deprive Netflix of its preferential terms of service or extend the same terms to other DVD rental companies, have blocked all attempts at reform.

Since 2002, Postal Service employees with knowledge of the Netflix problem have repeatedly urged the Postal Service to assess a nonmachinable surcharge to cover the added costs of processing the company's reply mailers manually. Tr. 4/163 (GFL9) (email **[BEGIN PROPRIETARY]** **[END PROPRIETARY]** dated September 23, 2003) (urging adoption of a nonmachinable surcharge for DVD reply mailers "to keep mailers from inundating the postal service with mail that is more difficult to process"); Tr. 4/173-76 (GFL22-23) (email from **[BEGIN PROPRIETARY]** **[END PROPRIETARY]** dated March 25, 2002) ("This CD is not, repeat not machineable mail and they should not be getting discounts for it. National [personnel] has not been in the field to watch this CD damage good machineable mail like we have. **[BEGIN PROPRIETARY]**

[END PROPRIETARY] Tr. 4/172 (GFL21) **[BEGIN PROPRIETARY]**

[END PROPRIETARY] Tr. 4/206-207 (GFL108-109) (proposal to impose nonmachinable surcharge on letter-size mail that receives manual processing at the request of the sender); Tr. 4/247 (GFL311) (email from **[BEGIN PROPRIETARY]** **[END PROPRIETARY]** dated Feb. 22, 2006) ("I really

think that a non-machinable surcharge needs to be applied if the mailers continue to insist the piece is not automation compatible. We knew that culling Netflix at the AFCS was going to open the door to other mailers requesting the same treatment.”); Tr. 4/285 (GFL458) (“it appears that the majority of this mail (98%) is being captured at the AFCS and then manually put into EMM trays. . . . My question is if so much of this mail is being manually trayed, where are the savings. This must be costing us **[BEGIN PROPRIETARY]** **[END PROPRIETARY]** to process.”); Tr. 4/383 (GFL2423) (email dated September 13, 2006) **[BEGIN PROPRIETARY]** **[END PROPRIETARY]**

Other Postal Service officials have expressed concern that the special treatment given to Netflix vis-à-vis other DVD rental companies could be challenged as unfair discrimination. On May 16, 2005, **[BEGIN PROPRIETARY]** **[END PROPRIETARY]** a headquarters operations specialist, wrote:

Major competitors are entering the DVD mail rental market. **[BEGIN PROPRIETARY]**

[END PROPRIETARY]

Tr. 4/180 (GFL30) (emphasis added); USPS response to GFL/USPS-125(a) (identifying **[BEGIN PROPRIETARY]** **[END PROPRIETARY]** as author of statement) (C247).

In September 2005, a Postal Service Headquarters employee wrote that “this situation is unstable **[BEGIN PROPRIETARY]**

[END PROPRIETARY] Tr. 4/158 (GFL1).

In the same month, a headquarters employee reminded participants in the Postal Service's Round-Trip Disc Mail working group that "the Postal Service had the responsibility of working with all mailers, large-volume or small-volume." Tr. 4/355 (GFL769); *see also* Tr. 4/358 (GFL805) (noting possibility of "Complaint Case" involving "Blockbuster or **[BEGIN PROPRIETARY]** **[END PROPRIETARY]**"); Tr. 4/363 (GFL869) (raising question of whether "Netflix competitors" are "being assessed/waived the same postage and fees in a 'fair and equitable' manner"); Tr. 4/256 (GFL347) ("[A]ny national codification of Pacific's SOP will certainly be met with [Blockbuster's] insistence on equal treatment).

In December 2005, **[BEGIN PROPRIETARY]**

[END PROPRIETARY] noted, in a PowerPoint presentation to **[BEGIN PROPRIETARY]** **[END PROPRIETARY]** and others associated with the Rate Case Advisory Group and the round trip disk mail working group, that the problems with the Postal Service's processing policies for DVD mailers included "breakage and damage of DVDs"; "nonmachinability of DVDs"; and "favoritism of one customer." Tr. 4/290 (GFL466); USPS response to GFL/USPS-136 (C254-255); *see generally* Tr. 4/288-97 (GFL464-473). The presentation added:

[BEGIN PROPRIETARY]

[END PROPRIETARY] Tr. 4/296 (GFL472).

[BEGIN PROPRIETARY]

[END PROPRIETARY] also wrote to the group in

October 2005:

[BEGIN PROPRIETARY]

[END PROPRIETARY]

Tr. 4/583 (GFL80339).

[BEGIN PROPRIETARY] **[END PROPRIETARY]** a headquarters Operations Specialist responsible for Netflix-related operational issues, made essentially the same point in February 2006:

There is no way the AFCS is set up to cull and separate DVDs for two different mailers—and who knows how many more requests we are going to receive.—I really think that a non-machinable surcharge needs to be applied if the mailers continue to insist the piece is not automation compatible. We knew that culling Netflix at the AFCS was going to open the door to other mailers requesting the same treatment.

Tr. 4/247 (GFL311); *see also* USPS response to GFL/USPS-133(d) (identifying **[BEGIN PROPRIETARY]** **[END PROPRIETARY]**) (C251).

[BEGIN PROPRIETARY]

[END PROPRIETARY]

As noted above, the OIG found in its November 2007 report noted that the classification of the Netflix DVD mailpiece as machinable was inconsistent with the findings of the Engineering Department that the “identical” mailpiece of another DVD rental company was nonmachinable—an inconsistency that “may lead mailers to perceive that the Postal Service shows favoritism toward some DVD rental services companies.” Tr. 4/282 (GFL 445).

Netflix, however, has resisted *both* paying a surcharge to cover the added costs of its custom processing *and* redesigning its mailer to tolerate automated processing.

[BEGIN PROPRIETARY]

[END PROPRIETARY] Confronted with Netflix’s resistance to change, Postal Service management has consistently backed down.

In November 2004, a member of the Postal Service headquarters operations group reported that Netflix was unwilling to participate in a Negotiated Service Agreement for its mail because Netflix did not want its DVD return mailers to receive more automated letter processing. Tr. 4/216 (GFL189) (statement by **[BEGIN PROPRIETARY]** **[END PROPRIETARY]** (“Netflix isn’t [interested in NSA] because they don’t want it on auto.”); USPS response to GFL/USPS-127(c) (C249).

In 2005, the Postal Service considered establishing an experimental or permanent classification for Round-Trip Disk Mail. **[BEGIN PROPRIETARY]**

[END PROPRIETARY] For example, the window on the back of the Netflix return mailer would have had to be eliminated. See Tr. 4/200 (GFL72). **[BEGIN PROPRIETARY]**

[END PROPRIETARY] Netflix vigorously opposed any design requirement that would require Netflix to pay higher rates. See Tr. 4/541 (GFL77808); Tr. 4/539 (GFL77698) (“we must keep the total mail piece weight to a maximum of 1 oz.”); Tr. 4/201 (GFL74) **[BEGIN PROPRIETARY]**

[END PROPRIETARY] *see also* Tr. 4/368 (GFL1236); Tr. 4/369 (GFL1241).

Despite investing significant resources to the effort, the Postal Service ultimately abandoned it, at least in part because of the **[BEGIN PROPRIETARY]**

[END PROPRIETARY] The Postal Service's decision to abandon the classification for Round-Trip Disc Mail and instead maintain the status quo, **[BEGIN PROPRIETARY]**

[END PROPRIETARY]

In February 2006, **[BEGIN PROPRIETARY]**

[END PROPRIETARY] noted in an email to **[BEGIN PROPRIETARY]** **[END PROPRIETARY]**

that

mailers, particularly Netflix, have been less than enthusiastic about adopting the design of the USPS-developed two-way mailer to improve machineability of their mailers. Part of Netflix's rationale for not adopting the USPS mailers is the belief that processing of their mailers on the AFCS is causing an increase in disk damage. Thus, they prefer that their disks are culled at the AFCS and processed manually (although they have not yet volunteered to pay a manual surcharge).

Tr. 4/310 (GFL523); *accord* Tr. 4/216 (GFL189) (November 2004 note reporting that "Netflix isn't [interested in a round-trip mailer NSA] because they don't want [their mailer] on auto."); Tr. 4/292 (GFL468) ("Breakage can be reduced by culling – But mailer does not want to pay surcharge for manual handling"); Tr. 4/354-55 (GFL768-GFL769).

To be fair to Netflix, it has not refused to pay *anything* extra for the culling, manual processing and other special handling it receives. In September 2005, counsel for Netflix suggested at a meeting with the Postal Service that Netflix “might consider a small additional charge for the special handling”—“perhaps . . . \$0.01 per piece for the manually culled return piece”—in exchange for allowing Netflix to “simply continue to receive the special handling in our opening operations for return mail.” Tr. 4/355 (GFL769).

Unwilling to confront Netflix, the Postal Service has backed down repeatedly, continuing to give Netflix's DVD mailers special handling with no extra charge—not even the one-penny surcharge suggested by Netflix. See Tr. 4/216 (GFL189), Tr. 4/354-55 (GFL768-769), Tr. 4/375-76 (GFL1484-1485), Tr. 4/310 (GFL523).¹⁴

¹⁴ The Postal Service has granted Netflix a variety of other preferences not offered to GameFly and smaller DVD mailers. These have included Netflix-only drop slots in post office lobbies, a practice that the Postal Service has admitted was improper. USPS responses to GFL/USPS- USPS Responses to GFL/USPS-28 (Retail Digest, May 4, 2007, p. 2, first item on page), 78, 79 and 80 (C206-215, C227-229, C230-231, C232-233). Presiding Officer's Ruling No. C2009/1-5 (issued Sept. 28, 2009) directed the Postal Service either to conduct a survey of the extent of Netflix-only drop slots at local post offices, or stipulate that other post offices “have mail slots that have been improperly designated as being solely for Netflix mail.” *Id.* at 18. The Postal Service accepted the stipulation rather than perform the survey. USPS Status Memorandum (Feb. 8, 2010) at A-1 to A-2 (discussing GFL/USPS-28).

The Postal Service also has given Netflix personnel extraordinary license to enter mail processing facilities, observe day-to-day mail processing operations there, and pressure Postal Service employees to process the mail in the manner desired by Netflix. See Tr. 4/329 (GFL543) (“Customer service representatives from Netflix, have been visiting our Plants to observe outgoing operations which captures Netflix DVD's being returned from their customers. This is a National account worth well over 300 million dollars annually.”); Tr. 4/239-42 (GFL275-278) (email from area plant manager in Oklahoma) (“Oklahoma is not unique, Netflix is meeting with various postal officials throughout the Area and nation.”). **[BEGIN PROPRIETARY]**

[END PROPRIETARY] These interactions apparently occur “throughout the . . . nation.” Tr. 4/239 (GFL275). **[BEGIN PROPRIETARY]**

II. THE POSTAL SERVICE'S PREFERENTIAL TREATMENT OF NETFLIX CONSTITUTES ILLEGAL DISCRIMINATION.

A. The Legal Elements Of A Discrimination Claim Under 39 U.S.C. § 403(c)

39 U.S.C. § 403(c) states that the Postal Service, “[i]n providing services and in establishing classifications, rates, and fees . . . shall not, except as specifically authorized in this title, make any undue or unreasonable discrimination among users of the mails, nor shall it grant any undue or unreasonable preferences to any such user.” Under Section 403(c) and cognate statutes, discrimination occurs when “(1) two classes of customers are treated differently, and (2) . . . the classes of customers are similarly situated.” *Energy Transfer Partners, L.P.*, 120 FERC ¶ 61,086 at P 169 (2007) (C490). “Undue discrimination is in essence an unjustified difference in treatment of similarly situated customers.” *Transwestern Pipeline Co.*, 36 FERC ¶ 61,175 at 61,433 (1986) (C542); *see also Sea-Land Service, Inc. v. I.C.C.*, 738 F.2d 1311, 1317 (D.C. Cir. 1984).

Section 403(c) codifies the longstanding tenet of utility and common carrier regulation that a regulated monopoly may not unduly discriminate among its customers

[END PROPRIETARY]

The intrusion of Netflix personnel into Postal Service field operations has provoked complaints from Postal Service employees. See Tr. 4/239 (GFL275) (email from Headquarters operations employee) **[BEGIN PROPRIETARY]**

[END PROPRIETARY] Despite these complaints, however, the Postal Service has declined to issue any rules or directives to limit the access of Netflix personnel to Postal Service personnel or facilities. USPS response to GFL/USPS-32 (C216).

or grant undue preferences to any particular customer. *See, e.g., Transcontinental Bus System, Inc. v. Civil Aeronautics Board*, 383 F.2d. 466, 475 (5th Cir. 1967) (“The granting of preferential and discriminatory rates in an indiscriminate manner was one of the abuses, among others, which gave rise to the passage of the Interstate Commerce Commission Act.”). This prohibition is one of the most fundamental principles of common carrier and public utility regulation. “Individual favoritism” among ratepayers was regarded during the Granger Era of the 1870s and 1880s as the “greatest evil chargeable against” a regulated monopoly, and prohibitions against undue discrimination were codified in Sections 2 and 3(1) of the Interstate Commerce Act from its inception in 1887. *See American Trucking Associations v. Atchison, T. & S.F. Ry. Co.*, 387 U.S. 367, 406 (1967) (“secret rebates, special rates to favored shippers, and discriminations . . . led to enactment of the Interstate Commerce Act in 1887”); David Boies and Paul R. Verkuil, *Public Control of Business* 15-24, 254-56 (1977); Solon J. Buck, *The Granger Movement* 11-14, 34 (1913). Section 403(c), like the antidiscrimination provisions of other federal regulatory statutes, is descended directly from Sections 2 and 3(1) of the 1887 Act.¹⁵

If anything, 39 U.S.C. § 403(c) is more rigorous than its antecedents in the Interstate Commerce Act, the Communications Act and the Natural Gas Act. Because the Postal Service, unlike privately-owned carriers such as railroads, gas pipelines and telecommunications carriers, lacks equity owners who could serve as a partial check on discrimination, the Commission must apply “a higher level of scrutiny for individualized rates than the ICC, the FCC, and the FERC.” *See* Docket No. MC2005-3, *Rate and*

¹⁵ These norms are also reflected in 39 U.S.C. §§ 101(d), 404(b) and 3622(b)(8), which provisions GameFly also relies on here.

Service Changes to Implement Baseline Negotiated Service Agreement with Bookspan, PRC Op. & Rec. Decis. (May 10, 2006) at 38-41.

The antidiscriminatory policies of Section 403(c) are also codified in 39 U.S.C. § 3622(c)(10), a provision added by PAEA to provide explicit authority for the Postal Service to enter into negotiated service agreements (“NSAs”) with individual customers. A prerequisite for any special classification or agreement with a customer under Section 3622(c)(10) is that the terms of the agreement must be made “available on public and reasonable terms to similarly situated mailers.” *Id.*

A claim of undue discrimination under these standards thus has essentially three elements. First, is the Postal Service offering better prices or terms of service to some DVD rental companies than to others? Second, are the favored and disfavored companies “similarly situated” to each other? Third, if the Postal Service is engaging in discrimination, is it “undue or reasonable”—i.e., lacking a rational and legitimate basis?

1. Differences among customers in rates or other terms of service.

To prevail under Section 403(c), a complainant must show that the Postal Service is offering a lower price or better terms and conditions of service to another ratepayer, but not to the complainant. *See, e.g.*, Docket No. MC79-3, *Red Tag Proceeding*, 1979, PRC Op. & Rec. Decis. (May 16, 1980) at 11; *American Trucking Associations v. Atchison, T. & S.F. Ry. Co.*, 387 U.S. 367, 406 (1967); *Transcontinental Bus System, Inc. v. Civil Aeronautics Board*, 383 F.2d. 466, 475 (5th Cir. 1967); *MCI Telecoms. Corp. v. FCC*, 917 F.2d 30, 39-40 (D.C. Cir. 1990). Section 403(c) and the cognate antidiscrimination provisions of other regulatory statutes cover not only

discrimination in pricing, but also discrimination in other terms and conditions of service. *Davis v. Cornwall*, 264 U.S. 560 (1924); *Chicago & A.R.R. v. Kirby*, 225 U.S. 155 (1912); Docket No. MC79-3, *Red Tag Proceeding*, 1979, PRC Op. & Rec. Decis. (May 16, 1980) at 11.

2. Similarity of the favored and disfavored customers.

The second element of a discrimination claim under Section 403(c) is a showing that the complainant is “similarly situated” or “functionally equivalent” to the favored ratepayer(s). *Experimental Rate and Service Changes to Implement Negotiated Service Agreement With Capital One*, MC2002-2 PRC Op. & Rec. Decis. (May 15, 2003) (“*Capital One NSA*”) ¶¶ 7011-7023; Docket No. MC79-3, *Red Tag Proceeding*, 1979, PRC Op. & Rec. Decis. (May 16, 1980) at 11-12, 19; *see also MCI Telecoms. Corp. v. FCC*, 917 F.2d 30, 39-40 (D.C. Cir. 1990); *Energy Transfer Partners, L.P.*, 120 FERC ¶ 61,086 at P 169 (2007) (C490); *Transwestern Pipeline Co.*, 36 FERC ¶ 61,175 at 61,433 (1986) (C542); *see also Sea-Land Service, Inc. v. I.C.C.*, 738 F.2d 1311, 1317 (D.C. Cir. 1984).

Substantial similarity or functional equivalence does not require that the circumstances of two similarly situated mailers be “the same” or identical. *Capital One NSA* at ¶ 7015. “Minor,” “incidental” or “immaterial” differences between two customers’ mail do not make them unlike. *Id.* at ¶¶ 7015-7021; *MCI*, 917 F.2d at 39. Thus, for example, it is immaterial to the question of functional equivalence or substantial similarity whether two ratepayers are the same size, generate the same amount of mail, impose the identical operating requirements on the Postal Service, cost the Postal

Service the same to serve, or have the same competitive options. *Capital One NSA* at ¶¶ 7020-7021, 7023.

3. Absence of a rational and permissible basis for the discrimination.

Proof of the above two elements establishes a prima facie case of discrimination, and shifts to the Postal Service the burden of showing that the discrimination is reasonable. It is here that differences between two similarly situated mailers may play a role. Appropriate proof that the discrimination is rationally related to differences in the Postal Service's costs of service or operational requirements can support a finding that the discrimination is reasonable and lawful. *See, e.g., MCI* at 39.

A threshold prerequisite for such a defense, however, is publication of the eligibility conditions for the preferred rate or service in a tariff-like publication such as the Mail Classification Schedule. Publication is a basic requirement of common carrier regulation and a fundamental protection against discrimination. Every regulatory agency with jurisdiction over common carriers, including this Commission, has held this filing requirement to be a necessary condition of the lawfulness of any rate charged or service provided by a common carrier.¹⁶

¹⁶ *See Rate and Service Changes to Implement Baseline Negotiated Service Agreement with Bookspan*, Opinion and Recommended Decision, Docket No. MC2005-3 at 38-39 (May 10, 2006) (specifically pointing to the public availability of the terms and conditions of the NSA and the ability of other mailers to obtain service on substantially the same conditions as support for holding the NSA nondiscriminatory); Docket No. RM2003-5, *Rules Applicable to Baseline And Functionally Equivalent Negotiated Service Agreements*, Order No. 1391 at 23 (Feb. 11, 2004) ("Public disclosure also provides transparency, which helps curtail arguments of discrimination and secret dealings The Commission will adhere to its preference, and presumption, that the contents of the actual contract shall be made publicly available."); *UPS Worldwide Forwarding v. United States Postal Service*, 66 F.3d 621, 635 (3d Cir. 1995) ("The

The Postal Service has contended that the filed rate doctrine is limited to formal contract rates. This claim is completely unfounded: the filed rate doctrine reflects a broad public policy against secret preferences that dates back to the origin of the Interstate Commerce Act. See, e.g., *AT&T v. Central Office Telephone, Inc.*, 524 U.S. 214, 221-224 (1998) (citing precedent supporting “filed rate doctrine”); *American Trucking Associations v. Atchison, T. & S.F. Ry. Co.*, 387 U.S. 367, 406 (1967) (“secret rebates, special rates to favored shippers, and discriminations . . . led to enactment of the Interstate Commerce Act in 1887”); *Louisville & Nashville R. Co. v. Maxwell*, 237 U.S. 94, 97 (1915) (“Under the Interstate Commerce Act, the rate of the carrier duly filed is the only lawful charge. Deviation from it is not permitted upon any pretext.”); *American Warehousemen’s Ass’n v. Ill. Cent. R. Co.*, 7 I.C.C. 556, 590, 591 (1898) (C438, 439); David Boies and Paul R. Verkuil, *Public Control of Business* 15-24, 254-56 (1977); Solon J. Buck, *The Granger Movement* 11-14, 34 (1913).

regulation promulgating the ICM program requires the Postal Service to ‘make every ICM service agreement available to similarly situated customers under substantially similar circumstances and conditions. . . . To facilitate that process, the regulation mandates that the Postal Service *publish detailed information* about each ICM agreement. . . . We believe the publication of this information will permit competitors and mailers alike to verify that the Postal Service is complying with its mandate not to grant ‘undue or unreasonable’ discrimination or preferences” (emphasis added); *AT&T v. Central Office Telephone, Inc.*, 524 U.S. 214, 221-224 (1998) (citing precedent supporting “filed rate doctrine”); *Sea-Land Service, Inc. v. ICC*, 738 F.2d 1311, 1317-1318 & n.12 (D.C. Cir. 1984) (quoting *Pennsylvania R.R. v. International Coal Mining Co.*, 230 U.S. 184, 196-97 (1913)) (“The published tariffs made no distinction between contract coal and free coal, but named one rate for all alike. That being true, only that single rate could be charged.”); *American Warehousemen’s Ass’n v. Ill. Cent. R. Co.*, 7 I.C.C. 556, 590, 591 (1898) (C438, 439); *Bay Gas Storage Company, Ltd.*, 109 FERC ¶ 61,348 at 62, 616 (2004) (“[Federal Energy Regulatory] Commission policy generally favors disclosure of individual jurisdictional contract information in order to ensure that the pipeline’s contracting practices are not unduly discriminatory, and no undue preferences are granted to any customer.”) (C443).

4. Illustration: the *Red Tag* case

Docket No. MC79-3, *Red Tag Proceeding, 1979*, illustrates the relationship of these elements. At issue in this proceeding was the “Red Tag” service provided to certain time-sensitive periodicals. This service, provided at regular periodicals rates at no extra charge, granted preferential handling to daily and weekly periodicals, while denying the same handling to monthly periodicals. In fact, non-red tag mailers could not obtain Red Tag service even if they were willing to pay extra for it. The Commission determined that “it is unduly discriminatory for non-red tag mailers to pay the same rate that red-tag mailers pay, and receive a lesser quality of service.” Docket No. MC79-3, PRC Op. & Rec. Decis. (May 16, 1980) at 11.

The Commission further explained that this “serious and illegal discrimination” resulted in part because “there is no rational relationship between the present eligibility requirements for red-tag service, and a mailer’s need for the expedited delivery that red-tag offers.” *Id.* at 12. In other words, the service was offered only to a select group of mailers arbitrarily selected from the broader group of periodicals mailers. To remedy this discrimination, the Commission recommended “that red-tag service be made available to any mailer willing to pay the differential.” *Id.* In doing so, the Commission recognized the fundamental principle that services can only be considered non-discriminatory if they are made available to all similarly situated parties. The Commission explained:

First, red-tag service is significantly different from ordinary second-class service. Second, the significant difference in service leads to significant differences in cost characteristics of red-tag and ordinary second class service. Third, the failure to recognize this difference in cost characteristics in the [DMCS] amounts to undue discrimination. Fourth, this undue discrimination must be eliminated now.

Id. at 19.

B. The Postal Service Offers Very Different Terms And Conditions Of Service To Netflix And GameFly.

That the Postal Service offers substantially different terms and conditions of service to GameFly and Netflix is obvious and indisputable. As discussed above, the Postal Service diverts most of the return mailers of Netflix from automated letter processing at no extra charge, while refusing to offer comparable terms and conditions of service to GameFly and other DVD rental companies. This disparity forces GameFly to incur \$0.61 extra per mailer-trip in postage (the difference between the two-ounce flats rate of \$1.05 and the one-ounce letter rate of \$0.44), as well as additional amounts for the cost of a larger mailer with a protective insert, to achieve the bypass of letter automation that Netflix obtains at the one-ounce letter rate with no extra charge. Joint Statement ¶¶ 48, 60-62; Glick Direct (GFL-T-1) at 1-2 (Tr. 4/137-138).

C. GameFly And Netflix Are Similarly Situated Within The Meaning of Section 403(c).

As shown in Section I, the record also establishes that the mail service used by GameFly is indisputably “like,” “functionally equivalent to” and “similarly situated to” the mail service used by Netflix. Both companies use First-Class Mail to ship DVDs in mailers to and from subscribers. Both companies’ DVDs are small and light enough to be mailed as one-ounce letters if sent in lightweight mailers. And both companies’ DVDs suffer from high breakage rates if subjected to automated letter processing when mailed back from subscribers.

The Postal Service does not dispute these facts. It argues, however, that GameFly and Netflix are dissimilar because: (1) GameFly pays flats rates, while Netflix pays letter rates; (2) GameFly is unwilling to expose its mailpieces to the supposedly greater risk of theft posed by manual processing; (3) GameFly's mailers lack a design as conspicuous as Netflix mailers; (4) GameFly has failed to pursue the design fixes developed by USPS witness Lundahl and his company, ATR, for Netflix; (5) Netflix enters its outbound mailers deeper into the postal system than GameFly does; (6) Netflix collects its return mailers from the Postal Service at more locations than GameFly does; and (7) Netflix DVD mailers are concentrated in greater volume at most Postal Service facilities than do GameFly DVD mailers. Barranca (USPS-T-1) at 8-11, 26-27, 30 (C141-144); Belair (USPS-T-2) at 8-9, 18-19 (Tr. 9/1600-01, 1610-11); Seanor (USPS-T-3) at 9-10, 17-19, 20-21 (C166-190); Lundahl (USPS-T-4 at 2) (Tr. 7/1214). In fact, none of these differences render GameFly and Netflix dissimilar with the meaning of Section 403(c).

Treating the first three distinctions as material would amount to blaming the victim. GameFly's choices do not arise from inherent differences between GameFly and Netflix, but are self-defense measures taken by GameFly to mitigate the damage it would otherwise suffer from the Postal Service's refusal to offer Netflix-like levels of manual processing to GameFly at machinable letter rates. Using mailers with protective inserts and entering them at automated flats rates, while much more costly than entering paying one-ounce letter rates, is the least bad alternative open to GameFly in the circumstances. Tr. 3/107-108 (Glick); Tr. 5/888 (Hodess). As long as GameFly must use this alternative, there is no reason to use a more conspicuous mailpiece design. If the Postal Service provided Netflix levels of manual processing to GameFly pieces entered at machinable letter rates, GameFly hereby stipulates that it would be

willing to enter its pieces as letters, and to mark the pieces more brightly and conspicuously. *Accord*, Tr. 11/1963 (Glick).

Likewise, unless and until the Postal Service offers Netflix levels of manual processing to GameFly for pieces entered at machinable letter rates, GameFly has no rational reason to pursue the design fixes developed by Mr. Lundahl and ATR. As explained above, the ATR design fixes are insufficient to prevent most of the disk breakage caused by automated letter processing, and unnecessary to achieve acceptable levels of disk breakage when the pieces receive automated flats processing with a protective mailer insert. The method GameFly has chosen to protect its discs, enclosing its disc in a mailer with a protective cardboard insert and entering that mailer as a flat, by contrast, has proven effective in reducing disc damage. See USPS-T-2 at 10, 14, 17 (Tr. 9/1602, 1606, 1609) (USPS witness Belair recognizing that GameFly has achieved a breakage rate similar to that of Netflix through these methods). Moreover, the possibility of additional reductions in breakage rates from adoption of the Lundahl fixes is irrelevant under Section 403(c) because changes in breakage do not affect the costs of the *Postal Service*. Tr. 11/1974 (Glick).

The remaining distinctions advanced by the Postal Service—the depth of entry into the Postal System, the number of Netflix and GameFly collection points, the resulting difference in average length of haul, and the greater volume of Netflix pieces—are immaterial to the question of whether GameFly and Netflix are substantially similar under Section 403(c). As explained above, substantial similarity requires only that the service sought by two mailers be *similarly situated*, not identical. *Capital One NSA* at ¶ 7015. “Minor,” “incidental” or “immaterial” differences between two customers' mail do

not make them unlike. *Id.* at ¶¶ 7015-7021; *MCI*, 917 F.2d at 39. Thus, for example, it is immaterial to the question of functional equivalence or substantial similarity whether two ratepayers are the same size, generate the same amount of mail, impose the identical operating requirements on the Postal Service, cost the Postal Service the same to serve, or have the same competitive options. *Capital One NSA* at ¶ 7020-7021, 7023.

To be sure, the cost differences that result from operational differences of this kind, if large enough, could provide a rational basis for price differences large enough to cover the cost differences. As we demonstrate in subsection D, however, none of the operational differences seized upon by the Postal Service rise to this level of materiality.

D. The Discrimination Among DVD Rental Companies Is Undue And Unlawful.

Because the existence of discrimination among DVD rental companies is undisputable, the Postal Service retreats to the second line of defense under 39 U.S.C. § 403(c): that any discrimination in favor of Netflix and against GameFly is “due,” “reasonable,” and hence lawful. Specifically, the Postal Service asserts that the discrimination among DVD rental companies in the processing of DVD reply mailers is justified because:

- (1) Postal Service headquarters officials have left the choice of processing methods for DVD reply mailers to the discretion of Area, District or other officials in the field.

- (2) The discrimination in favor of Netflix is justified by costs. The Postal Service saves money by culling and giving manual processing to Netflix inbound mailers.
- (3) The Postal Service lacks the capacity to give Netflix-level custom processing to the return mailers of other DVD rental companies.

Each of these defenses is factually unsupported; legally insufficient, or both. We discuss each defense in turn.

1. **The Postal Service cannot evade compliance with Section 403(c) by acquiescing in discrimination by employees in the field.**

As explained above, the Postal Service has generally implemented manual culling and processing of Netflix return mailers through directives issued by Areas, Districts and local officials rather than by Headquarters. The Postal Service has suggested in this case that the decentralized nature of these decisions bars any challenge by GameFly on grounds of undue discrimination. *See, e.g.*, USPS responses to GFL/USPS-23(d), 68 and 70(c), (d) (C201-202, C222, and C223). The Postal Service, however, cannot wash its hands its hands of responsibility for undue discrimination on the theory that the key decisions were made in the field, not at headquarters.

First, 39 U.S.C. § 403(c) bars undue discrimination and preferences by “the Postal Service”—not just by “Postal Service headquarters.” *Cf. Boynton v. Commonwealth of Virginia*, 364 U.S. 454 (1960) (racial discrimination by restaurant in the Trailways bus terminal in Richmond, Virginia, violated former 39 U.S.C. § 316(d), which barred “undue or unreasonable preference” or “prejudice” by “any common carrier

by motor vehicle” in interstate commerce, even though the restaurant was owned and operated by a tenant of Trailways, not by the bus company itself). Hence, undue discrimination is actionable under 39 U.S.C. § 403(c) even if Postal Service headquarters officials were unaware of the discrimination.

Second, and in any event, the fingerprints of Postal Service headquarters officials are all over the key decisions that led to this case. The 2002 decision to classify the Netflix mailpiece as machinable was a headquarters decision—and one that remains uncorrected three years after the 2007 OIG report urged headquarters management to take corrective action. See pp. 42-43, *supra*; Tr. 10/1885 (Seanor). Headquarters officials have known for years of the high rate of manual processing received by Netflix, and the continuation or growth of this practice after the issuance of the 2007 OIG Report, but have deliberately chosen not to stop this practice or otherwise rein in local discretion over the processing of Netflix return mailers.¹⁷ Moreover, the acquiescence of headquarters officials in the ongoing discrimination has not reflected a belief that headquarters was powerless to eliminate it. To the contrary, USPS witness

¹⁷ USPS Responses to GFL/USPS-23(b)-(e), 24, 25, 70(f), 86 (C201-202, C203-204, C205, C223, C236); Joint Statement ¶¶ 79, 87, 90; Tr. 4/304 (GFL517); Tr. 4/641 (GFL81093) **[BEGIN PROPRIETARY]**

[END PROPRIETARY] The Postal Service’s acquiescence in manual processing of DVD return mailers at field offices was a deliberate policy approved by the “[s]enior management of the Postal Service.” USPS Response to GFL/USPS-88 (C237); see also Tr. 4/375-76 (GFL1484-85) (October 9, 2005, email from **[BEGIN PROPRIETARY]**

[END PROPRIETARY] summarizing their discussions and dinner meeting during his site visit to the Netflix Sunnyvale Operations Center, and noting the continued need for “culling of our returns prior to getting into the automation stream”); Tr. 4/586 (GFL80740) (Feb. 16, 2006, email from **[BEGIN PROPRIETARY]**

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Seanor conceded that the discrimination between Netflix and Gamefly could be ended by a headquarters or other nationwide directive if the Postal Service chose. Tr. 10/1814, 1819 (Seanor).

Presiding Officer's Ruling No. C2009/1-10 (issued November 4, 2009) established three rebuttable presumptions:

Senior management of the Postal Service was aware that (a) a significant portion of the return DVD mailpieces of Netflix was culled manually and condoned this conduct; (b) that some of the areas and districts had such standard operating procedures in place and condoned them; and (c) that Netflix has been actively "lobbying" field personnel to an appreciable degree.

Id. at 5-6. The ruling directed the Postal Service to "provide any evidence upon which it may rely to refute a presumption within the next two weeks to avoid the risk of surprise."

Id. at 6 n. 11. The Postal Service did not try to refute the presumptions, and they are now irrefutable.

2. The extra costs of the special processing given to Netflix mail far exceed the savings to the Postal Service.

The Postal Service also defends its discrimination on the theory that the special processing given to Netflix saves the Postal Service money. According to the Postal Service's witnesses, the Postal Service's pervasive discrimination in favor of Netflix has nothing to do with minimizing disk breakage. Rather, the preference is justified by costs: the Postal Service saves money by culling and giving manual processing to Netflix inbound mailers. Local operating officials, despite having no data or analyses to support their decisions, have a preternatural ability to order manual culling of DVD

mailers when—and only when—it is the low cost solution. Belair (USPS-T-2) at 11 (Tr. 9/1603); Seanor (USPS-T-3) at 7 (C175); *accord*, Barranca (USPS-T-1) at 15-16, 30-31 (C148-49; 163-64).

These claims are absurd, and the Postal Service should be embarrassed at making three of its employees take the witness stand to defend them. No Postal Service study supports them, and they are refuted by a host of Postal Service documents, including the Christensen Associates study and the Postal Service's own stipulations and institutional discovery responses in this case.

As explained above, the main reasons for Postal Service culling of Netflix pieces from automated processing are to reduce DVD breakage, jams, and other processing problems, not because culling is a low-cost process. Moreover, the Postal Service admitted in response to discovery that the Postal Service “has not performed the necessary calculations” to determine how often manual processing of Netflix mail is more economical. USPS response to GFL/USPS-71(b) (C225); USPS response to GFL/USPS-73(b) and (d) (“This response is not predicated on any studies.”); USPS response to GFL/USPS-162(a) (the response to GFL/USPS-71(b) “was not based on any specific calculations”) (C258). The Postal Service has also admitted that manual processing is not more economical than automated letter processing at any of the sites studied by Christensen Associates:

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Mr. Glick's analysis of the Christensen Associates cost models confirms that these admissions are correct. As detailed in his rebuttal testimony, he 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. His analysis shows that the average cost of the Postal Service's current methods of processing Netflix returns incur **[BEGIN PROPRIETARY]** **[END PROPRIETARY]** the cost of processing these pieces on letter automation. Glick Rebuttal (GFL-RT-1) at 29-31 and App. A (Tr. 12/2038-2044).¹⁸

The Christensen studies constitute the best evidence of record on this issue. The Postal Service has admitted that the Christensen study is the best—and only—study of its kind. USPS response to GFL/USPS-163(c) **[BEGIN PROPRIETARY]**

[END PROPRIETARY] Christensen Associates is a highly respected economic consulting firm, and it produced the report with input from knowledgeable subject matter experts from Postal Service headquarters. This was a study by the Postal Service's "A team." Tr. 12/2075-2076 (Glick).

¹⁸ Mr. Glick calculated the incremental cost of the special treatment Netflix receives by comparison with the cost of a fully machinable Netflix return that is sorted on letter automation. This approach is correct (indeed, necessary) because allowing Netflix to mail pieces that are effectively nonmachinable at machinable letter rates is part of the special treatment Netflix receives. This is, by definition, a "self-imposed wound." Tr. 11/1940 (Glick). Consistent with the recommendations set forth in the 2007 OIG report (which the Postal Service still has not implemented three years later), Netflix returns should be eligible for the 44-cent rate that it pays only if those pieces are effectively machinable. GFL-RT-1 at 28, fn. 19 (Tr. 12/2037); GFL696 (C13).

Moreover, the results of the Christensen analysis are highly robust. The enormous difference shown by the Christensen data between the cost of the custom processing received by Netflix and cost of automated processing of genuinely machinable letters dwarfs the potential effect of any of the methodological quibbles that the Postal Service has raised about the data and methodology of the Christensen study. Tr. 12/2055-2056 (Glick cross-examination).

Indeed, the Postal Service itself has relied on the Christensen study repeatedly. See GFL703 (response of USPS management to OIG Report; relying on the cost estimates developed in the Christensen report) (C20); USPS answers to GFL/USPS-17 and 18 (admitting that the Postal Service used the Christensen and OIG reports to estimate the relative amounts of manual vs. automation letter processing received by Netflix and another DVD rental company) (C196-198 and C199); **[BEGIN PROPRIETARY]**

[END PROPRIETARY] Tr. 10/17889, 1792-93, 1795 (USPS witness Seanor) (citing Christensen report as support for his position on the efficiency of culling Netflix mail at the point of collection); Tr. 12/2049-2050 **[BEGIN PROPRIETARY]**

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The conclusions warranted by the Christensen Associates study are supported by a wide variety of less formal analyses created within the Postal Service before and

after the Christensen reports. As **[BEGIN PROPRIETARY]**

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PROPRIETARY] observed in 2005:

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[END PROPRIETARY] *see also* Tr. 4/188 (GFL58), Tr. 4/205 (GFL107), Tr. 4/285 (GFL458) (“if so much of this mail is being manually trayed, where is the savings? This must be costing us a **[BEGIN PROPRIETARY]** **[END PROPRIETARY]** to process”); Tr. 4/359 (GFL845), Tr. 4/370 (GFL1335), Tr. 4/372 (GFL1359), Tr. 4/373 (GFL1360); USPS response to GFL/USPS-147 (C257); Tr. 4/218 (GFL211) (Test Results of USPS 2-Way DVD Mailer Machineability and Automation Test dated March 4, 2005) (“Although Mailers were enjoying automation rates for their [2-way DVD mailer], most pieces were being handled as flats or manually, resulting in financial losses to the postal service; Tr. 4/367 (GFL1115) (note from **[BEGIN PROPRIETARY]** **[END PROPRIETARY]** estimating that USPS losing \$75,000 a day from manual processing of return DVDs); Tr. 4/378 (GFL1664) **[BEGIN PROPRIETARY]**

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PROPRIETARY] Tr. 4/372 (GFL1359) (estimating that extra labor cost of manual processing totaled \$61.5 million in FY 2008 and FY 2009).

In August 2005, Headquarters Pricing and Classification employees estimated that **[BEGIN PROPRIETARY]**

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In the same month, **[BEGIN PROPRIETARY]**

[END PROPRIETARY] advised other senior headquarters officials that:

We have had discussions of how to adjust to DVDs in the mail data the rates group review. At NOVA (and they are not dummies) the plant is asking the collection people to pull them out for manual processing. If they are still in the mailstream, every AFCS operating is individually pulling them out. The fundamental belief is that a DVD is not flexible enough to be handled as a letter mail piece. *This is costing us a HUGE increment over an average letter mail automated rate on the returns. . . .*

Tr. 4/383 (GFL2423) (capitalization in original; italics added).

In the same year, the Postal Service estimated that providing manual processing to a one-ounce letter without collecting a nonmachinable surcharge essentially eliminates any contribution to institutional costs from the piece. Tr. 4/205 (GFL107).

See also **[BEGIN PROPRIETARY]**

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An internal Postal Service analysis reported in 2009 that “a large return volume [of DVD mailers was still being] processed manually at the mailers’ request. Manual processing of DVDs imposes undue expenses on the USPS.” Tr. 4/370 (GFL1335). Other USPS studies have reached the same conclusion.

Against this mass of evidence, the Postal Service offers only the unsupported assertions of two field operating officials. The officials, Larry Belair and Troy Seanor, dutifully insist that manual processing of Netflix return mailers, when it occurs, occurs because it is the most efficient course. USPS-T-2 at 11 (Belair) (Tr. 9/1603); USPS-T-3 at 7 (Seanor) (C175). How do we know that this is true? Because, explain Messrs. Belair and Seanor, local operating officials are under tight budget constraints, so whatever they do must be the most efficient of all possible choices. Tr. 10/1834-1836 (Belair); Tr. 9/1710-1715 (Seanor).¹⁹ Messrs. Belair and Seanor conceded on cross-examination, however, that their hunches were unsupported by data, analyses or studies. Tr. 9/1626, 1627, 1634, 1691 (Belair); Tr. 10/1757 (Seanor answer to GFL/USPS-T3-16); Tr. 10/1793 (Seanor) (admitting that the Christensen study is the only study commissioned by the Postal Service on the costs and benefits of manual culling). Compared with the analyses cited above, particularly the rigorous and comprehensive work performed by Christensen Associates with input from headquarters officials, the Panglossian fantasy that the Postal Service has concocted for this case cannot be taken seriously.

¹⁹ The Postal Service might as well have added that efficiency is in the “organization’s DNA.” R2010-4 Tr. 59 (August 10, 2010) (testimony of USPS witness Joseph Corbett).

In sum, the Postal Service's purported cost justification for its discrimination among DVD rental companies is as unsupported as the supposed cost justification for the discrimination at issue in Docket No. MC79-3, *Red Tag Proceeding, 1979, supra*. Red-tag mailers tried to justify their preference in service on the theory that their publications cost the Postal Service less to handle than other periodicals, and that the red-tag service was fair compensation for the benefits these mailers thus provided the Postal Service. *Red Tag Op. & Rec. Decision* at 27-28. The Commission rejected this claim as unsubstantiated. *Id.* at 28. The same finding is warranted here.

3. The Postal Service has offered no evidence that variations in "local conditions" justify the preferences given to Netflix.

A variation of the Postal Service's efficiency argument is that leaving the processing methods used for Netflix return mailers to local discretion maximizes efficiency by allowing local operations to match local conditions. See USPS-T-3 at 7, 11 (C175; 179); USPS-T-1 at 15-16 (C148-149). This is another crude exercise in revisionism. The Postal Service has offered no data or analyses to support the witnesses' hypothesis. To the contrary, the Postal Service has identified variations in local operating practices of this kind as a major source of *inefficiency*. As the Postal Service noted at the beginning of this year, "Standardization has a major role in improving service and efficiency in all operations and support activities." FY 2009 Comprehensive Statement on Postal Operations (at 23) (quoted in Glick Direct, GFL-T-1 at 6-7 (Tr. 3/85-86)). Moreover, the Postal Service's *internal* correspondence indicates that the "local variation" defense is merely a fig leaf to shield the preferential treatment of Netflix from scrutiny and thwart demands for equal treatment or potential discrimination claims by other DVD rental companies. See Tr. 4/256-57 (GFL347-348) (internal USPS email correspondence)

("As I know you know, any national codification of Pacific's SOP [which authorized custom handling of Netflix return DVD mailers] will certainly be met with [Blockbuster's] insistence on equal treatment."). *See also* Tr. 4/248-49 (GFL315-316), Tr. 4/251-53 (GFL327-329); Tr. 4/254 (GFL337).²⁰

The hollowness of the "local variation" defense is underscored by the repeated willingness of headquarters officials to override local management discretion by imposing national operating procedures. In July 2002, for example, a senior manager of distribution operations issued a directive providing that "any Netflix incoming BRM mail in each processing unit will immediately be isolated and dispatched directly to the caller service area of the box section." Tr. 4/165-71 (GFL12-18).

Similarly, in September 2002, **[BEGIN PROPRIETARY]** **[END PROPRIETARY]** a senior USPS operations executive, sent a memorandum to Area, District and Plant managers throughout the United States promulgating mandatory steps for "NETFLIX Service Improvement." The memorandum directed, among other things, that:

- "Processing facilities should target and isolate all NETFLIX inbound mailpieces in a staging area for Caller Service pick-up, not the box section."

²⁰ The Pacific Area offered a similar rationalization in its own SOP in 2007. The Pacific Area officially rescinded the SOP in December 2007 "due to increasing volume from other DVD vendors being received and processed." Response of USPS to GFL/USPS-106(a)-(b) (reproduced at end of Tr. vol. 10). "[N]o formal SOP has been issued to replace the rescinded Area SOP, however," and "processing of Netflix in the Pacific Area continues to be substantially similar to that set forth in the SOP." Response of USPS to GFL/USPS-106(d) (reproduced at end of Tr. vol. 10) (C241).

- “To prevent any damage when the mail is being handled or transported, the letter-size mailers should be placed in EMM trays in lieu of flat containers (tubs).”

Tr. 4/298-99 (GFL495-96); Tr. 4/164 (GFL10) (Memorandum dated September 12, 2002); *see also* Tr. 4/306 (GFL519) (illustrated instructions stating that Netflix return mailers should not be processed “on the AFCS and DBCS”); Tr. 4/307-09 (GFL520-522) (letters from Headquarters directing Postal Service facilities to process Netflix mail in accordance with special procedures).

Likewise, in 2005, Headquarters officials explicitly instructed field employees to follow special traying and container handling procedures for Netflix DVD return mailers. *See* Tr. 4/307 (GFL520) (Memorandum dated February 15, 2005, from **[BEGIN PROPRIETARY]** **[END PROPRIETARY]** to all P&DC plant managers); Tr. 4/308 (GFL521) (Memorandum dated May 9, 2005, from **[BEGIN PROPRIETARY]** **[END PROPRIETARY]** to all Area Operations Vice Presidents).

4. Differences in the volume, length of travel and other operating characteristics of Netflix and GameFly mail have only a minor effect on costs, and cannot justify the discrimination between the two companies.

The Postal Service has also tried to justify its discrimination against GameFly on the theory that GameFly has less mail volume, lower volume density, fewer mail pickup points and longer transportation distances than does GameFly. Seanor (USPS-T-3) at 21 (C189); Barranca (USPS-T-1) at 8 (C141); Belair (USPS-T-2) at 11-12 (Tr. 9/1603-04). The record

makes clear that these differences have only a minor impact on costs, and thus cannot justify the discrimination between Netflix and GameFly.

The Postal Service fails to explain how differences in mail volume and density would significantly affect costs. If all DVD mailers were diverted from automated processing, the combined volume and volume density of the culled DVD mailers would, by definition, be as great or greater than the volume and volume density of Netflix mailpieces alone.

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.” See also Glick Rebuttal (GFL-RT-1) at 17-18 (Tr. 11/1923-24, 12/2026-27).

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. Belair (USPS-T-2) at 3 (Tr. 9/1595); Seanor (USPS-T-3) at 1 (C169). 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. Glick Rebuttal (GFL-RT-1) at 18 (Tr. 11/1924, 12/2027).

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. Glick Rebuttal (GFL-RT-1) at 18-19 (Tr. 12/2027-2028); Tr. 11/1963-1965, 1984-1987 (Glick cross-ex). A September 12, 2002 letter from **[BEGIN PROPRIETARY]** **[END PROPRIETARY]** a senior USPS operations executive, 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." Tr. 4/164 (GFL10). Yet, manual processing of Netflix mail was being reported around this time or shortly thereafter. See Tr. 4/159 (GFL4) (timeline noting that by June 24, 2002, many USPS sites were "handling [Netflix] return mailers manually (culling from AFCS)"); Tr. 4/161-63 (GFL7-9) (detailing manual processing by September 2003 even though the plants in question were not receiving large volumes of Netflix mail); Tr. 4/183 (GFL35) **[BEGIN USPS PROPRIETARY]**

[END USPS PROPRIETARY]; Tr. 4/279 (GFL428) (July 17, 2003 email ("It seems almost everyone is processing this [Netflix] mail manually."); Glick Rebuttal (GFL-RT-1) at 18-19 (Tr. 11/1924-25, 12/2027-28).

Nevertheless, as a condition to relief in this case, GameFly is willing to pay the (minimal) extra costs of transportation and container handling that result from the greater average travel of its pieces in the Postal Service system. Tr. 11/1965 (Glick).

5. The alleged infeasibility of giving all DVD rental companies the same level of service cannot justify discrimination in favor of one or two customers.

In the early stages of this case, the Postal Service defended the preferences offered to Netflix on the further ground that offering Netflix-level culling and manual processing to GameFly and other DVD rental companies would require an impractically large number of containers and additional sorting operations. It is unclear whether the Postal Service still advances this defense. In any event, the defense fails in several ways.

First, it is factually unsupported. As the Postal Service admitted in response to a follow-up discovery request, “[n]o study has been done to determine the maximum number of parties for which such culling would be feasible. No study been done to identify the operational feasibility of culling return mailpieces for multiple parties at the point of collection, or what the maximum number of such parties may be.” USPS Response to GFL/USPS-162(f)-(g) (C258-59) (asked whether Operations believed it would be operationally feasible to implement manual culling process for multiple parties). In other words, the Postal Service has no idea whether it is operationally possible to provide culling and manual processing for additional DVD rental companies.

Second, even if the Postal Service were truly incapable of providing Netflix-level culling and manual sorting to all DVD rental companies who requested it, this incapacity would be insufficient as a matter of law to justify discrimination in favor of Netflix (or any other subset of the DVD rental companies who request Netflix-level service). It is a longstanding principle of law that capacity constraints do not justify discrimination among the customers of a regulated monopoly. See, e.g., *Pennsylvania R.R. Co. v. Puritan Coal Mining Co.*, 237 U.S. 121, 133 (1915) (acknowledging that while a railroad cannot be expected “to transport more than he could carry,” the law “requires that [carriers] should be equally reasonable in the treatment of their patrons” and that “they are bound to treat shippers fairly, if not, identically” in the case of a shortage of capacity); *Belle Fourche Pipeline Company*, 28 FERC ¶ 61,150 at 61,281 (1984) (same rule for oil pipelines) (C446); *Amerada Hess Pipeline Co.*, 68 F.E.R.C. ¶ 61,057, at 61,196 (1994) (“If the pipeline receives more requests for service than it can accommodate, it must prorate its capacity among shippers”) (C403).

In *Belle Fourche Pipeline Company*, Belle Fourche filed a tariff stating that it “reserves the right in the event of Tenders in excess of its facilities or capacity to make equitable apportionments or to refuse any such Tender in order to limit accepted Tenders to an amount which will be within the capacity of its facilities.” 28 FERC ¶ 61,150 at 61,281 (1984) (C445). The Federal Energy Regulatory Commission held, however, that such a reservation “appears to be directly at odds with the obligations of a common carrier.” *Id.* Referring to the prohibition against undue discrimination of section 3(1) of the Interstate Commerce Act—the cognate provision to 39 U.S.C. § 403(c)—the FERC ruled that “a provision which allows a pipeline to transport the tender of one shipper in

its entirety while refusing to transport any of the oil tendered by another shipper would seem to be unlawful on its face.” *Id.*

Belle Fourche makes clear that the Postal Service may not violate its duty to serve the public evenhandedly by rejecting a request for Netflix-level culling and manual processing from another customer on the theory that the Postal Service lacks the capacity to meet that customer’s request. Such a policy is unlawful for the reasons explained by the FERC in *Belle Fourche*.

Indeed, the unlawfulness of the discrimination at issue here is even more flagrant than in *Belle Fourche*; the pipeline at least had published its policy of rejecting shipments when capacity fell short of total volume tendered for shipment. In contrast, the Postal Service has not published its preferences for Netflix vis-à-vis other mailers in the MCS, the DMM or any other tariff-like publication. This failure to publicly establish the grounds on which a customer can be denied service is an independent ground for invalidating as discriminatory a scheme for allocating scarce capacity. *See, e.g., Amerada Hess Pipeline Co.*, 68 F.E.R.C. ¶ 61,057, at 61,196 (1994) (C403). Only through publicly available policies can postal customers “determine whether assignment of prorated capacity among shippers is performed in a nondiscriminatory and nonpreferential manner.” *Id.*

In fact, even a published, facially non-discriminatory policy may be unlawful if it vests too much discretion in the carrier to pick and choose among its customers. *See Koch Pipelines, Inc.*, 63 FERC ¶ 62,104 at 64,177 (1993) (suspending a proposed tariff because “[t]he vagueness of the prorating language appears to leave Koch with

excessive discretion in determining which shipper nominations will be accepted for shipment.”) (C499).

In sum, a claim that practical limitations justify withholding Netflix-level culling and manual processing from other DVD rental companies is directly analogous to a claim by a pipeline that it discriminate among customers when a pipeline has reached its capacity, or to a claim by a railroad that it discriminate among freight shippers when demand for transportation exceeds the railroad’s line capacity or car supply. The precedent cited above requires rejection of this defense.

6. The Postal Service’s discrimination between Netflix and GameFly cannot be justified as a means of meeting service standards or critical dispatch times.

Postal Service witnesses Belair and Seanor have also asserted that diversion of Netflix mailpieces from automated letter processing helps meet the critical dispatches needed to satisfy service standards. See Belair, USPS-T-2 at 5 (Tr. 9/1597); Seanor, USPS-T-3 at 7, 17-18 (C175, 185-86). This testimony can be given no weight. The Postal Service specifically stated in discovery that meeting service standards is *not* a major reason for manually culling Netflix returns:

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 (reproduced at end of Tr. vol. 10) (C390-91). See also Tr. 10/1795 (discussion of USPS Response to GFL/USPS-67); Tr. 9/1691 (Belair) (no studies showing that culling Netflix mail helps meet service standards); Seanor Response to USPS-T3-23 (Tr. 10/1766) (same); Tr. 10/1794 (Seanor) (same, despite Mr. Seanor’s claim that culling helps meet standards).

The emptiness of the “meeting service standards” defense is underscored by the fact that the Postal Service’s service standards for market-dominant products were revised in December 2007 pursuant to Section 301 of the Postal Accountability and Enhancement Act, 39 U.S.C. § 3691, which requires the Postal Service to establish and maintain “modern” service standards. *Modern Service Standards for Market-Dominant Products*, 72 Fed. Reg. 72216 (December 19, 2007). Service standards that could be met only by substituting high-cost manual culling for lower cost automated processing would be inconsistent with this statutory directive.

Finally, and in any event, the proposition that meeting service standards requires pervasive manual culling of the DVD mailers of Netflix, but no other DVD rental company, would be legally insufficient to justify the discrimination against GameFly and others even if factually correct. Such a claim is merely a variation of the argument that capacity constraints prevent a common carrier from serving all comers evenhandedly. As discussed above, capacity limitations cannot justify discrimination by a regulated monopoly; any capacity shortfalls must be apportioned in a nondiscriminatory fashion.

7. The preferences given to Netflix also violate the filed rate doctrine.

The facts in this case differ from *Red Tag* (and many of other the cases cited above) in one major respect: the allegedly discriminatory rules in the earlier cases were at least published in the Domestic Mail Manual, the DMCS or some other tariff-like publication. The preferences the Postal Service has granted to Netflix and Blockbuster, by contrast, do not appear in any rate or classification scheduled published in the DMM, the MCS or any other public document. In fact, in many cases, many of the preferences

received by Netflix, including systematic culling and manual processing, directly *contravene* the Postal Service's published classifications. Thus, regardless of whether the Postal Service can put forth a rational justification for the preferences granted Netflix and denied GameFly, these preferences are *per se* illegal because they amount to rates and classifications that have never been properly published.

One of the most fundamental rules of public utility and common carrier regulation is the filed rate doctrine—the prohibition against offering rates or service on terms that vary from the rates and classifications set forth in the lawfully published tariffs. In postal regulation, the filed rate doctrine was codified by the Postal Reorganization Act at 39 U.S.C. §§ 3622-3625. Any change in rates, fees or classifications required the USPS to submit a request under former 39 U.S.C. § 3622 (rates) or 3622 (classifications) for Commission approval of the rate or classification change under former 39 U.S.C. § 3624. If the PRC recommended the rate change, the USPS could implement it through a decision of the Governors under former 39 U.S.C. § 3625. The resulting rate and classification changes were published in the DMCS. The law authorized no other procedure for changing postal rates or fees.

Although PAEA has greatly streamlined the rate approval process, the Postal Service may not implement an “adjustment in rates” until after giving at least 45 days notice to the Commission and the public under 39 U.S.C. § 3622(d)(1)(C). “Rates” are defined to include “fees for postal services.” 39 U.S.C. § 102(7). The notice must satisfy the requirements recently prescribed by the PRC in RM2007-1 and codified at 39 C.F.R. §§ 3010.10-3010.29.

Another provision of PAEA, codified at 39 U.S.C. § 3622(a), directs the Commission to regulate “classes” as well as “rates” for market dominant products. The rules adopted by the Commission under Section 3622(a) maintain a tariff-like filing requirement for classification changes as well. 39 C.F.R. § 3020.91.

39 U.S.C. § 3622(c)(10), another provision added by PAEA, underscores the continued force of the filed rate doctrine. Section 3622(c)(10) authorizes the Postal Service to establish negotiated service agreements in appropriate circumstances. A prerequisite for any NSA, however, is that the terms of the agreement must be made “available on *public* and reasonable terms to similarly situated mailers.” *Id.* (emphasis added). PAEA clearly forecloses the Postal Service’s unpublished terms and conditions of service for Netflix, which amount to a black-market NSA.

The filed rate doctrine is an essential corollary of Section 403(c) and similar prohibitions against unjust discrimination among ratepayers. *See AT&T v. Central Office Telephone, Inc.*, 524 U.S. 214, 221-224 (1998) (citing precedent supporting “filed rate doctrine”); *American Warehousemen’s Ass’n v. Ill. Cent. R. Co.*, 7 I.C.C. 556, 590, 591 (1898) (C438, 439); *Bay Gas Storage Company, Ltd.*, 109 FERC ¶ 61,348 at 62, 616 (2004) (“[Federal Energy Regulatory] Commission policy generally favors disclosure of individual jurisdictional contract information in order to ensure that the pipeline’s contracting practices are not unduly discriminatory, and no undue preferences are granted to any customer.”) (C443).

The filed rate doctrine requires publication of classifications and material terms of service, not just rates. *AT&T v. Central Office Telephone, supra*, 524 U.S. at 223-226 (filed rate doctrine applies to “classifications, practices and regulations affecting” rates

as well as rates themselves); *UPS Worldwide Forwarding v. USPS*, 66 F.3d 621, 635 (3d Cir. 1995); Docket No. RM2003-5, *Rules Applicable to Baseline And Functionally Equivalent Negotiated Service Agreements*, Order No. 1391 (Feb. 11, 2004) at 23; *Rate and Service Changes to Implement Baseline Negotiated Service Agreement with Bookspan*, PRC Op. & Rec. Decis. (May 10, 2006) at 38-39, 42.

Because the Postal Service has provided preferential service to Netflix without publishing the terms and conditions of that service as required by Title 39, mailers such as GameFly have been deprived of these procedural protections against discrimination. Thus, the preferences offered to Netflix would be illegal even if the Postal Service could muster a rational justification for them.²¹

III. REMEDIES

Given the Postal Service's chronic inability or unwillingness to end the discrimination between Netflix and other DVD rental companies, the Commission must break the impasse by ordering the Postal Service to end the discrimination. *See Suncor Energy Marketing Co., Inc. v. Platte Pipe Line Co.*, 132 FERC ¶ 61,242 at P 137 (2010) (ordering pipeline to implement a proration policy proposed by shippers to remedy concerns about discrimination raised in complaints and protests brought under the

²¹ Postal Service employees have expressed concerns about this. *See* Tr. 4/576 (GFL80128) **[BEGIN PROPRIETARY]**

[END PROPRIETARY]

Interstate Commerce Act) (C529-530).²² GameFly proposes that the Commission order the Postal Service to implement one or both of the following remedies.

The first is for the Postal Service to offer every DVD rental company manual culling and manual processing of DVD mailers entered at machinable letter rates to the same extent that Netflix receives. This remedy must be defined in terms of a measurable and enforceable quantitative outcome—i.e., at least 80 percent of the customer’s DVD volume must be diverted from automated processing—not just in general or aspirational terms. The manual processing must include each of the following elements: **[BEGIN PROPRIETARY]**

[END PROPRIETARY] Glick Rebuttal (GFL-RT-1) at 7 (Table 1) and App. A, Table A-2 (Tr. 12/2016 and 2043); *see generally* pp. 22-23, *supra*. The remedy must be implemented through a headquarters directive or another directive of national scope and effectiveness.

²² In *Suncor*, FERC relied on its authority under section 15(1) of the Interstate Commerce Act, which empowers FERC to “determine and prescribe what will be . . . what . . . regulation, or practice is or will be just, fair, and reasonable, to be thereafter followed” in the event that it finds, in a complaint proceeding, that a carrier’s current practices are unjust, unreasonable, or unduly discriminatory. The PRC has similar authority under 39 U.S.C. § 3662(c), which provides that if the Commission finds a complaint to be justified, it “shall order that the Postal Service take such action as the Commission considers appropriate in order to achieve compliance.”

Moreover, there must be periodic reporting to the Commission to provide current and precise data on the extent to which the Postal Service is actually achieving the minimum required level of manual processing. If the rate of manual processing falls below the target, then the alternative remedy discussed below (reduced rates for flat-shaped DVD mailers) should take effect immediately.²³

The second alternative remedy is for the Postal Service to establish a reduced automation rate for *flat*-shaped DVD mailers sent and received by GameFly, with the rate set to produce an average per piece contribution to institutional costs equal to the per piece contribution that the Postal Service receives from Netflix DVD mailers entered at letter rates. As GameFly witness Glick explained in his direct testimony, a rate for flat-shaped DVD mailers set in this way would be approximately one dollar per round trip before application of any presort discounts.²⁴ This alternative rate should be made available to other DVD rental companies too.

²³ GameFly takes no position on whether the Postal Service should impose a nonmachinable surcharge on DVD mailers. That is an issue for the Postal Service to decide. If a surcharge is imposed, however, it must be imposed without discrimination on all DVD mailers whose pieces are nonmachinable, including those of Netflix.

²⁴ **[BEGIN PROPRIETARY]**

[END PROPRIETARY]

CONCLUSION

The Postal Service's practice of giving Netflix custom processing of DVD return mailers at no extra charge, while denying the same terms to GameFly and others, constitutes unlawful discrimination under 39 U.S.C. § 403(c) and other provisions of Title 39. The law requires that this discrimination be eliminated.

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