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

COMPLAINT OF GAMEFLY, INC.	)))	Docket No. C2009-1R
COMPETITIVE PRODUCT LIST ADDING ROUND-TRIP MAILER	)))	Docket No. MC2013-57
COMPETITIVE PRODUCT LIST ADDING ROUND-TRIP MAILER (MC2013-57)	)))	Docket No. CP2013-75

COMMENTS OF GAMEFLY, INC.
ON USPS PROPOSAL TO RECLASSIFY DVD MAILERS
AS COMPETITIVE PRODUCTS

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ON USPS PROPOSAL TO RECLASSIFY DVD MAILERS
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(August 15, 2013)

Pursuant to Order No. 1794, GameFly Inc. respectfully submits these comments on the Postal Service's July 26 request to transfer round-trip DVD mailers from the market dominant product list to the competitive product list under 39 U.S.C. § 3642 on September 30, 2013, the Commission-set deadline for reducing to 46 cents the price for flat-shaped DVD mail. The Postal Service asserts that its market power over DVD mail has been eliminated by competition from (1) streaming and downloading of video entertainment over the Internet and (2) DVD rental kiosks.

These claims are a fantasy. Neither mode of competition would protect Netflix or GameFly from a significant rate increase if the Commission exempted DVD mail from maximum rate regulation by reclassifying the product as competitive under 39 U.S.C. § 3642(b)(1). Neither supposed form of competition is a viable substitute for the distribution of DVDs by mail to the millions of American households that still prefer to receive video entertainment and games from DVDs by mail. Both Netflix and GameFly have stated this, and the conduct of the Postal Service confirms it.

In any event, depriving DVD rental companies of the protection of maximum rate regulation is unnecessary to avoid forcing the Postal Service to bank its unused CPI-based rate increase authority when the Commission-prescribed price reduction takes effect on September 30. On August 13, 2013, the Commission confirmed that equalizing the price of letter- and flat-shaped DVD mailers while continuing to treat them as market-dominant First-Class Mail, will not require an immediate recalculation of available CPI pricing authority. Order No. 1807 at 7-10.

For all of these reasons, the long-delayed elimination of undue discrimination against GameFly should not come at the cost of leaving users of DVD mail unprotected against unreasonably high prices.

I. THE POSTAL SERVICE HAS FAILED TO PROVE THAT IT FACES EFFECTIVE COMPETITION FOR DVD MAIL.

The differences between this product transfer proposal and previous cases under 39 U.S.C. § 3642 are stark. For the first time since Congress enacted Section 3642 in 2006, the Postal Service is seeking to exempt from maximum rate regulation a mail product that faces no competition from private carriers such as UPS and FedEx. In previous Section 3642 cases, the Commission found that the Postal Service faced effective competition from competing private carriers that were willing and able to carry the same matter for the same customers between the same origins and destinations. *See* Order No. 689, Docket No. MC2010-36, *Transferring Commercial Standard Mail Parcels to the Competitive Product List,* (March 2, 2011); Order No. 710, Docket No. MC2011-22, *Restructuring First-Class Mail Parcel Product Offerings* (April 6, 2011); Docket No. MC2012-13, *Transfer of Parcel Post to the Competitive Product List* (July 19, 2012). In the present case, by contrast, the Postal Service admits that it "does not know of another shipping company that provides door-to-door delivery of optical discs such as DVDs." USPS Request, Attachment A, Steven W. Monteith Statement of Supporting Justification ("Monteith") at 3.

Instead, the Postal Service relies entirely on the asserted effectiveness of two more indirect forms of competition: (1) competition between DVDs and electronic streaming or downloading over the Internet; and (2) retail kiosks, which require consumers to transport rental DVDs to and from the retail stores themselves. Monteith at 3-4. These indirect forms of competition, the Postal Service claims, are good enough substitutes that the Postal Service would "likely" "suffer declines in volume" if it raised prices or degraded service for DVD mail. *Id.* at 4. The only evidence mustered in support of this claim, however, is a single news story from Bloomberg.com and a handful of snippets from the most recent Netflix 10-K report indicating that streaming video has gained audience share over DVDs-by-mail in the past few years. *Id*.

None of this "evidence" answers the real questions: (1) whether the demand for DVD mail is sufficiently price-elastic to make a significant price increase unprofitable; (2)

whether Netflix and GameFly, and their DVD-by-mail customers, regard Internet streaming or downloading as viable substitute channels for the content these customers currently obtain from DVD-by-mail; (3) whether retail kiosks would be a cost-effective substitute method of distributing rental DVDs to these subscribers; and (4) whether the Postal Service's conduct toward DVD rental companies is consistent with the behavior of a firm in a competitive market. In fact, all available evidence indicates that even a large increase in the price of DVD mail would cause little reduction in DVD mail volume, and that the price increase would be profitable for the Postal Service.

In Part A of this section, we summarize the legal standards for assessing competitive claims of this kind. In Part B, we discuss the available price elasticity data. In Parts C and D, respectively, we provide a structural analysis of the competition for DVD mail service for video entertainment (Netflix) and games (GameFly). Finally, in Part E, we consider whether the Postal Service's conduct towards its DVD mail customers is consistent with the behavior of a firm that faces effective competition.

A. The Governing Legal Standards

To justify transferring a market dominant product to the competitive product list, the USPS must show that it no longer "exercises sufficient market power that it can effectively set the price of such product substantially above costs, raise prices significantly, decrease quality, or decrease output, without risk of losing a significant level of business to other firms offering similar products." 39 U.S.C. § 3642(b)(1); 39 C.F.R. § 3020.32(d). Section 3642(b)(1) codifies a standard test for market power—whether a firm can increase profits through a small but significant non-transitory increase in price ("SNIPP"). *See CF Industries, Inc. v. Surface Transportation Board*, 255 F.3d 816, 821-24 (D.C. Cir. 2001) (citing judicial precedent and antitrust treatises). If so, as in the present case, the firm has market power.

As noted by the Commission in the Commercial Standard Mail Parcels decision, "Section 3642(b)(1) is intended to prevent the transfer of market dominant products to the competitive product list if the Postal Service enjoys such market power that it could raise rates or reduce service to the detriment of consumers without significant consequences, as defined. Market power might result from constraints on competition due to monopoly powers granted to the Postal Service. Alternatively, market power may be due to extraneous factors that limit the entry of competitors into the marketplace or limit the ability of existing competitors to compete such that the Postal Service would have a free rein to raise rates or reduce service without the steadying hand of competition." Order No. 689 at 14. In the context of the competition asserted in the Postal Service's July 26 request, these standards effectively require the Postal Service to show that raising the price of DVD mail significantly, or significantly degrading the quality of mail service, would cause DVD-by-mail rental companies to shift a significant share of their current mail volume to distribution through retail outlets, or replace rental DVDs with Internet streaming or downloading. *Accord*, *CF Industries, supra*, 255 F.3d at 822-824.

Because the Postal Service has never before tried to justify a product transfer under Section 3642 based solely on the supposed effectiveness of indirect competition of this kind, this is a case of first impression for the Commission. The analytical tools for assessing such claims are well-developed, however. Other public utility and common carrier regulators, the Department of Justice, the Federal Trade Commission, and the courts in antitrust cases have paid considerable attention to the standards for evaluating the effectiveness of purported competition that differs substantially in kind from the regulated service. In particular, several other regulators administer statutes that provide for lighter regulation (or no regulation at all) of maximum rates on products or services for which the regulated firm lacks market dominance (i.e., faces effective competition). The relevant precedent may be summarized as follows:

(1) The ultimate test, as noted above, is whether a firm can raise its prices significantly without causing the quantity demanded to fall enough to make the price increase unprofitable. In mathematical terms, the issue depends on the own-price elasticity of demand for the product. *CF Industries*, *supra*.

(2) When supposedly competing products differ noticeably from the products whose market dominance is at issue, the primary question is whether buyers consider the former to be close enough substitutes for the latter to constrain their pricing. Stated otherwise, the question asked is whether the products are reasonably interchangeable in use. The factors considered in evaluating the interchangeability of products and services include: (1) the cross-elasticity of demand between the two products or services; (2) differences in price, type, grade or quality between the products or services; and (3) the extent of sunk investment by the customer in facilities that are compatible only with the product delivered by the incumbent carrier. *See generally*, ABA Section of Antitrust Law, Antitrust Law Developments (7th ed. 2012) at 572-589; *Arizona Public Service Co. v. United States*, 742 F.2d 644, 652-53 (D.C. Cir. 1984).

(3) This substitutability can be expressed in mathematical terms as the *cross* elasticity of demand between two products—i.e., the percentage change in the demand

for one product divided by a specified percentage change in the price of a potentially competing product. Antitrust Law Developments at 577. To provide relevant evidence on this point, the USPS would have to provide evidence sufficient for the Commission to understand how the cross-elasticity of demand for internet streaming or DVDs at retail kiosks has changed in response to changes in the price of DVDs-by-mail.

(4) Along with cross elasticities of demand, antitrust courts and regulatory agencies also look at factors such as the price, type, grade and quality of the services to assess whether the assertedly substitute products are in fact reasonably interchangeable. The question is whether differences in the price, type, grade or quality of two products cause purchasers to see them as not interchangeable despite their general similarity. *Arizona Public Service Co*, *supra*, 742 F.2d at 652-53. For example, the Supreme Court has found that championship boxing matches are not reasonably interchangeable with other boxing matches because a lower court found that championship matches drew more spectators at higher ticket prices, sold TV rights for more money, had higher Nielsen ratings and involved salable movie rights. *International Boxing Club v. U.S.*, 358 U.S. 242 (1959); *see also Omni Outdoor Advertising v. Columbia Outdoor Advertising*, 891 F.2d 1127 (4th Cir. 1989), *rev'd on other grounds sub nom. City of Columbia v. Omni Outdoor Adver*., 499 U.S. 365 (1991) (relevant market for advertising on billboards excluded other modes of advertising delivery such as newspapers, TV and radio). Determining whether purported substitutes are in fact reasonably interchangeable typically requires a highly fact intensive inquiry into the actual responses of consumers to the different product characteristics and prices. Antitrust Law Developments at 580. A claim that one

product is substitutable for another must be supported by substantial evidence, not "conjecture." *Arizona Public Service Co.*, *supra*, 742 F.2d at 653-55.

(5) When the putative competition is downstream competition between two different *products*—i.e., the *delivered product* carried by the regulated carrier (here, DVDs) versus a different product carried by some other means (here, streamed or downloaded video content)—a finding of effective competition requires a showing that the competition constrains not only the delivered price of the first product, *but also the price of its transportation component* (here, the price of DVD mail, an input to the delivered price of rental DVDs). The D.C. Circuit noted this distinction in the analogous context of railroad transportation of coal destined for export. Evidence that competition from foreign coal sources constrained the delivered price of American coal in foreign markets was insufficient to justify exempting coal transportation rates from maximum rate regulation, the court held. To be considered effective, the competition must also constrain the cost of the transportation component as well:

> Even if the world market is such that U.S. market share will decline as price increases, and indeed even if it would establish a world "price cap" above which market share would decline rapidly enough to reduce export coal profits, this would not protect American shippers from abuses of market power by railroads. The issue is not whether American interests have market power in the world coal market, but whether one component of the American export picture, railroads, have market power in relation to another component, coal producers and other shippers. Even if there is a "price cap" that prevents raising the delivered price of export coal, a railroad could still use monopoly power to raise rates to coal shippers and appropriate to itself an unreasonable portion of the profits generated by each shipment. Because of the cap, a captive shipper would be forced to lower its share of the total coal revenues if confronted with a rail rate increase. Although the existence of a world price cap for delivered U.S. coal means that foreign consumers will not have to pay a higher price, *it does not assure that the division of revenues between the railroads and U.S shippers will be a reasonable one*.

Coal Exporters Ass'n of United States v. United States, 745 F.2d 76, 84-85, 93, 95, 99 (D.C. Cir. 1984) (citations omitted; emphasis added); *accord*, *General Chemical Corp. v. United States*, 817 F.2d 844, 854 (D.C. Cir. 1987).

(6) The burden of proof rests with a regulated firm that seeks to reclassify a market dominant service as competitive. The Administrative Procedure Act places the burden of proof on the proponent of change. 5 U.S.C. § 556(d) ("Except as otherwise provided by statute, the proponent of a rule or order has the burden of proof."). Consistent with this, the Commission's rules place the burden on the Postal Service to "demonstrate why the change" in classification from market dominant to competitive is consistent with the statute. 39 C.F.R. § 3020.32(a). The same principles require that the Postal Service bear the burden of proving that it lacks effective competition in any particular market. *Cf*. FERC Stats & Regs. ¶ 31,007 at 31,179-80, 69 FERC ¶ 61,103 (1994), order on reh'g, Order No. 572-A, 69 FERC ¶ 61,412 (1994), *pet. for review denied*, *AOPL v. FERC*, 83 F.3d 1424 (D.C. Cir. 1998) (requiring that an "oil pipeline bear its burden of proof in a fashion that ensures there is no reliance on presumed market forces"); *Gulf South Pipeline Co., L.P., v. FERC*, No. 99-1424 (D.C. Cir., Apr. 23, 2002) (unpublished decision) (party seeking permission to charge market-based rates had the burden of proof to show that it lacked market power and, where it claimed that different products provided effective competition for natural gas transportation, had the burden of proving that the alternative service had a low enough price, and "a quality high enough to treat it as a substitute for" the service at issue).

(7) Finally, the state of competition relevant to a request to exempt a product from maximum rate regulation today is the competition that exists today, not what might

exist at some indefinite point in the future. *Cf*. *Coal Exporters Ass'n*, *supra*, 745 F.2d at 88 (ICC could not base finding of effective competition for railroad transportation on potential entry by coal slurry pipelines that had not yet been built).

B. The Postal Service's Claims of Effective Competition Are Contradicted By The Postal Service's Own Price Elasticity Data.

The Postal Service's July 26 request offers no cross-elasticity estimates at all, let alone any evidence that the own-price elasticity of demand for DVD mail service is negative enough that the percentage decline in volume caused by a price increase would outweigh the percentage gain in average contribution per piece, thus rendering the price increase unprofitable. Moreover, the own-price elasticity data reported by the Postal Service for the categories of First-Class Mail that encompass round-trip DVD mailers indicate that demand is quite insensitive to price. A recent Postal Service report, "Narrative Explanation of Econometric Demand Equations for Market Dominant Products Filed with Postal Regulatory Commission on January 22, 2013" (filed on July 1, 2013), reports the following price elasticities for First-Class Mail today:

First-Class Mail Single-Piece Letters and Cards:	- 0.090
First-Class Mail Workshared Letters, Cards, and Flats:	- 0.392
First-Class Mail Single-Piece Flats	- 0.265

Id. at 28, 30, 35. These elasticity values, if correct, imply that a ten percent price increase for these First-Class products would cause volume to decrease by only 9/10 of one percent, 3.92 percent, and 2.65 percent, respectively.[1] The net result of the increase would be an increase in profit, since total revenue would increase and the decline in volume would cause total costs to decline. This is strong evidence of market dominance: the ability to increase profits through a small but significant non-transitory increase in price ("SNIPP") is a well-accepted test of market power. *CF Industries, Inc. v. Surface Transportation Board*, 255 F.3d 816, 821-24 (D.C. Cir. 2001) (citing judicial precedent and antitrust treatises).

To be sure, the Postal Service's recent elasticity estimates apply to categories of First-Class Mail that are broader than DVD mail. But the Postal Service has offered no evidence that the demand for DVD mail service is more price-elastic than the demand for First-Class mail generally. Instead, the Postal Service simply *assumes* that, because the share of entertainment content delivered by Netflix to households via DVD–by-mail has declined vis-à-vis delivery via streaming, the demand for mail delivery of the remaining DVD volume (including game DVDs, which Netflix does not offer) must have become much more price elastic. Monteith at 4.

This assumption is a non sequitur. First-Class Mail is a perfect illustration. As the Commission is aware, competition from the Internet has caused massive declines in

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[1] A paper presented by several employees of and consultants for the Postal Service at the recent CRRI (Rutgers University) conference in Portmarnock, Ireland, made similar claims. *See* Bozzo, A. Thomas, Kristen L. Capogrossi, B. Kelly Eakin, John Pickett and Mithuna Srinivasan, "Is Demand for Market Dominant Products of the United States Postal Service Becoming More Own Price Elastic?" (presented at CRRI conference on May 30, 2013) (finding "no evidence that recent events such as the Great Recession and the mass adoption of broadband Internet services have led to material increases in the own price elasticities for market dominant products of USPS.").

the volume of many mail products in recent years, including every major product within First-Class Mail. *See*, *e.g.*, USPS Form 10-Q (May 10, 2013) at 26 ("The impact of technological change has been especially pronounced on our First-Class Mail revenues which continue to decline even as new services, the growth of e-commerce, and successful marketing campaigns, have helped us grow our Shipping and Packages revenues."); USPS FY 2012 Annual Report to Congress at 6 (noting "long-term projected declines in First-Class Mail volume"); USPS Plan to Profitability: 5-Year Business Plan (Feb. 16, 2012) at 3 ("[d]eclines in revenue are being driven by lower First-Class Mail volumes (down 25% since peaking in 2006)"); *Id.* at 5 ("Diversion of communications and commerce to electronic channels is a principal contributor to declining First-Class Mail volumes . . . Diversion reflects a permanent secular shift in consumer behavior . . .").

Likewise, the Postal Service report discussed above, "Narrative Explanation of Econometric Demand Equations for Market Dominant Products," emphasizes the importance of electronic diversion as a cause of the deep decline in First-Class Mail volume in recent years. *Id.* at 13-16, 27. For First-Class workshared letters, cards and flats, the report states (at 34):

> Prior to 2002, there was very little, if any, apparent Internet diversion of First-Class workshared mail (or, to the extent such diversion existed, its presence was offset by other factors). Over the past decade, electronic diversion of First-Class workshared mail has increased, in large part because of the growth in broadband internet access. More recently, negative economic conditions have acted as an additional trigger for increased diversion.

For single-piece First-Class letters, the report states (*id.* at 27): "The most critical factor affecting First-Class single-piece letters and cards volume over the past ten years has been the loss of this volume to electronic alternatives." For single-piece First-Class flats, the report likewise states (*id*. at 29): "The most critical factor affecting First-Class single-piece mail volume over at least the past ten years has been the loss of this volume to electronic alternatives." As noted above, however, the same report concludes that the remaining volume of First-Class Mail is quite price-inelastic.

C. Neither Netflix Nor The Seven Million Households That Rent Video DVDs By Mail From Netflix Regard Internet Streaming Or Retail Kiosks As Good Substitutes For DVD-By-Mail.

The elasticity data discussed in Part B are consistent with the structural evidence that neither DVD rental companies nor their customers consider internet streaming or downloading or retail kiosks to be good substitutes for DVD-by-mail. We discuss video DVDs in Part C and game DVDs in Part D.

1. Netflix's DVD-by-mail subscribers do not consider internet streaming a good substitute.

The heart of the Postal Service's case for reclassifying DVD mail as competitive is the fact that Netflix's video streaming business has gained subscribers in recent year, while the number of DVD-by-mail subscribers has declined. Monteith at 3-4. This fact, however, proves nothing about the substitutability of Internet streaming for the remaining seven million households that still rent DVDs by mail from Netflix.[2] In reality,

[2] The Postal Service does not separately analyze the substitutability of video streaming for Blockbuster, and neither will GameFly. The Postal Service has stated that Netflix and GameFly "together represent an overwhelming majority of round-trip DVD mail." USPS Response to Order No. 1794 (August 5, 2013) at 2 n. 4. GameFly has no reason to doubt this. Blockbuster is no longer a major player in the DVD-by-mail business. The company entered bankruptcy in 2010, and its assets were acquired by DISH Network in 2011. Since then, DISH has shuttered most of Blockbuster's remaining

most of those households consider streaming video a poor substitute. Perhaps most telling, two-thirds of Netflix's customers who subscribe to the company's DVD rental segment also subscribe to the company's streaming service *even through the subscriber must pay separately for each, with no combination discount*. Netflix letter to shareholders (October 23, 2012) at 9 ("Over two-thirds of these DVD members also subscribe to our streaming service."). If subscribers to DVD-by mail considered video streaming to be a good substitute, one would not expect so many subscribers to pay twice to receive both.

Consumers' judgments about the poor substitutability of streaming and DVDs are well founded. Streaming and DVDs have distinct characteristics. The most attractive feature of video streaming is the near-instant gratification it offers: a consumer can begin viewing streaming content almost immediately after ordering it. Furthermore, some first-run entertainment content is available only through streaming. But DVD-by-mail has several advantages of its own.

First, streaming requires broadband service to the household. In many rural areas of the United States, broadband service is either nonexistent or unaffordable. By contrast, any consumer whose household receives mail delivery can subscribe to DVD-by-mail. *See* Netflix Top Investor Questions (downloaded from http://ir.netflix.com/faq.cfm on Aug. 5, 2013) ("The overall market for DVDs is declining,

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brick-and-mortar outlets. Earlier this year, DISH stated that the remaining rental outlets have been hurt by, *inter alia*, "increasing competition from video rental kiosks, streaming *and mail order businesses*." DISH Network Corp. 2012 Form 10-K (Feb. 20, 2013) at 35 (emphasis added).

but there will likely be some persistent level of demand for DVD's, particularly in rural areas where broadband is not easily available or affordable.").

Second, the entertainment content available via streaming is much more limited than the content available on DVDs. Netflix's library of streaming titles consists largely of recent movies and TV shows, and the company continually allows older titles to drop out of the catalog by not renewing their licensing agreements. *See*, *e.g*., Bryan Bishop, "Netflix losing almost 1,800 titles from its streaming library," *The Verge* (April 30, 2013) (http://www.theverge.com/2013/4/30/4287902/netflix-losing-almost-1800-titles-from-its-streaming-library-starting-tomorrow). The number of back titles available via DVD-by-mail is far greater. Transcript of Netflix Q3 2011 Earnings Conference Call (October 24, 2011) at 5 ("DVD is still primarily a catalogue rental business where people like the incredible depth and breadth of the catalogue [of] over 100,000 titles"); Netflix letter to shareholders (October 23, 2012) at 9 ("DVD is a great reference format, and we carry nearly every DVD ever produced."); Netflix letter to shareholders (July 22, 2013) at 6 ("The huge selection we offer on DVD continues to be a draw for over 7 million households."). *See* Netflix Top Investor Questions (downloaded from http://ir.netflix.com/faq.cfm on August 5, 2013) ("Additionally, there will be some level of demand from members interested in the tremendous reference library available on DVD."). Subscribers to DVD-by-mail are less "engaged in terms of caring about the freshness of the date of the content." Transcript of Netflix earnings conference call (October 23, 2012) at 5 (statement of Netflix CFO David Wells).

This disparity is likely to persist for the foreseeable future. The price demanded by content producers for licensing content for streaming often exceeds what Netflix is willing to pay. *See*, *e.g.*, Netflix management letter to shareholders (July 22, 2013) at 2 (noting that Netflix allowed its content licensing deals with MTV Networks, Nickelodeon and Comedy Central to expire); Transcript of Netflix earnings conference call (July 22, 2013) at 16 (statement of Netflix chief content officer) (from negotiating content licenses, "you get to know what the walk-away prices are . . . there's definitely some competition in the marketplace, which does raise the prices" for content). By contrast, the "first sale" doctrine of intellectual property entitles a DVD rental company to buy a DVD at the same price that anyone else pays, and then rent out the DVD repeatedly to subscribers without further payment of royalties. 17 U.S.C. § 106(3) (codifying *Bobbs-Merrill Co. v. Straus*, 210 U.S. 339 (1908)); Transcript of Netflix earnings conference call (Oct. 24, 2011) at 5 ("DVD is partially high margin because of the US [first]-sale doctrine, where we can buy the DVD, pay for it once, and then rent it as long as we want.").

These differences in product characteristics have caused Netflix's customers to sort themselves into distinct markets in recent years. Consumers who consider near-instantaneous content delivery and ready access to new releases more important than a large variety of video titles have gravitated toward Internet streaming (at least if they have affordable access to broadband service). Consumers who lack broadband internet service, or who value access to Netflix's comprehensive back catalog more than speed of delivery, have stayed with DVDs-by-mail. And customers who value near-instant content delivery on demand, ready access to new releases, *and* access to a large catalog of titles tend to subscribe to both services. As Reed Hastings, the Chairman and CEO of Netflix, told a group of securities analysts in October 2011:

> I will tell you that the brand properties of DVD and streaming are quite different. DVD is complete, but it's got the by-mail aspect, which is quite slow. Streaming is instant and the selection is less. And so having separate brands representing really the different audiences that care about these two services can, in theory make sense.

Transcript of Netflix earnings conference call (ca. Oct. 24, 2011) at 4.

Netflix has tried hard in recent years to accelerate the growth of delivery via Internet streaming at the expense of DVDs by mail. The company's video streaming business, both in the United States and abroad, has received the lion's share of new investment capital, while Netflix's DVD-by-mail business has been treated as a cash cow to help subsidize the rest of the company. Transcript of Netflix earnings conference call (Oct. 24, 2011) at 5-6; Netflix Form 10-K for 2012 (Feb. 1, 2013) at 8. The DVD-by-mail business, however, has stubbornly survived. As of mid-2013, Netflix still has approximately seven million subscribers to DVD-by-mail. Netflix letter to shareholders (July 22, 2013) at 1. Moreover, the rate of decline of the DVD-by-mail subscription base has slowed. *See* Netflix Top Investor Questions (downloaded from http://ir.netflix.com/faq.cfm on Aug. 5, 2013) ("the rate of decline has slowed each quarter since we launched the DVD-only plan").

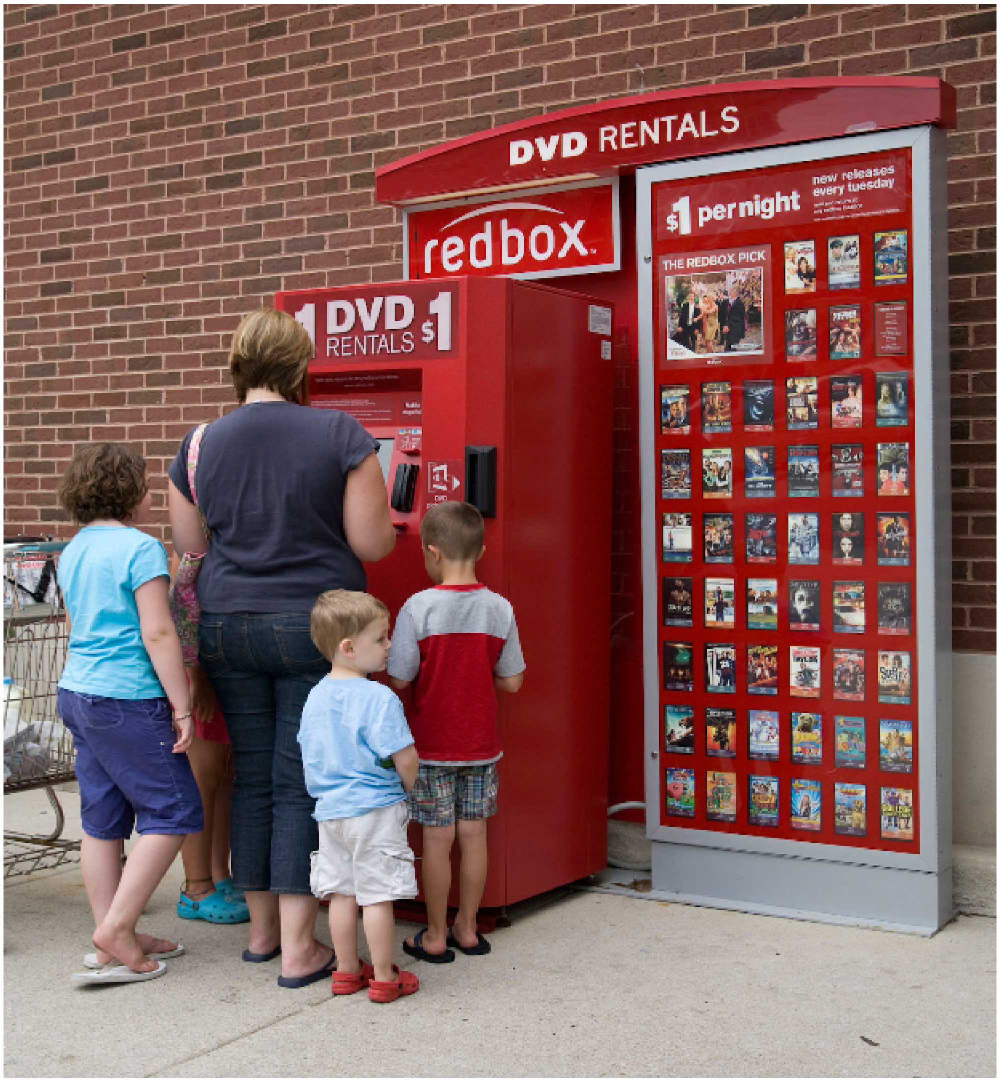
Furthermore, although Netflix's domestic streaming business has approximately four times as many subscribers, the DVD-by-mail business has much bigger profit margins, and still generates two-thirds as much total profit. Netflix CEO's letter to shareholders (July 22, 2013) at 1; Netflix 10-K report for 2012 at 22 (in 2012 the company's domestic DVD business had a contribution margin of 47 percent, almost triple the 16 percent margin of the domestic streaming business). Indeed, Netflix has even occasionally resumed marketing DVD subscriptions to streaming-only subscribers. Transcript of Netflix earnings conference call (January 23, 2013) at 10.

2. DVD distribution via retail kiosks is not a good substitute for Netflix's DVD-by-mail rental service.

The Postal Service also gains nothing from its offhand allusion to competition for entertainment DVDs-by-mail from "other physical DVD rental services such as Redbox®." Monteith at 4 (citing Netflix 2012 Form 10-K at 2). First, the notion that Netflix or anyone else could respond to a postal rate increase by building out a brand-new national network of full-service retail outlets has been tested and found wanting in the market. That business model was Blockbuster's; Netflix's DVD-by-mail model crushed it. As noted above, Blockbuster went bankrupt in 2010, and DISH Network, which purchased Blockbuster's assets out of bankruptcy, has closed most of the company's former retail outlets.

Distribution of merchandise through a network of retail stores has a major disadvantage compared with mail distribution of the same volume of merchandise from centralized warehouses and distribution center: a brick-and-mortar retail network costs more to operate. Retail distribution has large economies of scale. Distributing a given volume of merchandise from a single large distribution facility costs less than distributing the same volume of merchandise from a multiplicity of smaller facilities. The costs of real estate, labor, utility, equipment and inventory all have economies of scale. These scale economies have played a big part in the decline of independent retailers at the hands of large national chains; the decline of the same chains at the hands of Wal-Mart, which pioneered the use of giant regional warehouses; the decline of brick-and-mortar bookstores and other retailers, large and small, at the hands of Internet retailers like Amazon; and the demise of Blockbuster's retail network, primarily at the hands of Netflix. Hodess Decl. ¶¶ 13-17.

Redbox has succeeded where Blockbuster failed by adopting a radically stripped down store design. Redbox is the brand name of a network of about 44,000 automated self-service kiosks that offer DVDs, most of them videos, for rent. The kiosks are located primarily in supermarkets, drug stores, mass merchants, financial institutions, convenience stores, and restaurants—i.e., places that consumers visit primarily for other goods or services. Outerwall Inc. Form 10-Q (July 25, 2013) at 10-11. Redbox controls its distribution costs by leaving its kiosks unstaffed, and offering a severely limited selection of DVDs. A typical kiosk occupies a footprint of less than 10 square feet—about the size of a vending machine—and holds only about 600 DVDs, or about 200 different titles, at any time (Hodess ¶¶ 18-19):



Redbox appears to have been successful. But building a Redbox-like distribution network would not be a viable substitute for DVD-by-mail even if the Postal Service greatly raised the price of DVD mail service. As noted above, perhaps the strongest selling point of Netflix's DVD-by-mail service is its enormous catalog of titles. Vending-machine size retail kiosks, whether operated by Redbox or anyone else, are inherently incapable of matching this.

3. Netflix has acknowledged that it would have to incur losses if the Postal Service raised the price of DVD mail.

Recognizing that neither video streaming nor the self-service kiosk is a viable alternative way to the distribution of video DVDs by mail, Netflix has acknowledged that it would suffer if the price of DVD postage were to increase. Netflix's Form 10-K report for 2012 (Feb. 2013) admitted: "Changes in U.S. Postal rates or operations could adversely impact our operating results and subscriber satisfaction." *Id.* at 10. Netflix explained:

> We rely exclusively on the U.S. Postal Service to deliver DVDs from our shipping centers and to return DVDs to us from our subscribers. *Increases in postage delivery rates could adversely affect our Domestic DVD segment's contribution profit.* The U.S. Postal Service increased the rate for first class postage on January 23, 2013 to 46 cents. *It is expected that the U.S. Postal Service will raise rates again in subsequent years, which would result in increased shipping costs.* If the U.S. Postal Service were to change any policies relative to the requirements of first-class mail, including changes in size, weight or machinability qualifications of our DVD envelopes, such changes could result in increased shipping costs or higher breakage for our DVDs, and our contribution margin could be adversely affected. . . . If the U.S. Postal Service were to implement other changes to improve its financial position, such as closing mail processing facilities or service reductions, such changes could lead to a decrease in customer satisfaction and our results of operations could be adversely affected.

Id. (emphasis added). With specific reference to the GameFly complaint case, Netflix added:

> For example, the United States Court of Appeals for the District of Columbia recently instructed the Postal Regulatory Commission (PRC) to remedy discrimination by the Postal Service in the processing of DVDs by mail, or to explain adequately why such discrimination is reasonable. While we do not anticipate any material impact to our operations arising from this case, *if the PRC institutes a remedy that results in an increase in postage rates or changes the manner in which our DVD shipments are processed, our contribution margin could be adversely affected*.

Id. (emphasis added). Stated otherwise, a postal price increase would do precisely what the D.C. Circuit found to be proof of market power: capture rents at the expense of its customers' margins. *Coal Exporters Ass'n of United States v. United States*, 745 F.2d 76, 84-85, 93, 95, 99 (D.C. Cir. 1984) (citations omitted; emphasis added); *accord*, *General Chemical Corp. v. United States*, 817 F.2d 844, 854 (D.C. Cir. 1987).

D. GameFly has no competitive alternative to the Postal Service for delivering games to subscribers.

The Postal Service does not even bother to analyze the effectiveness of competition from the Internet or self-service kiosks as a constraint on the price of shipping game DVDs by mail. The answer, however, is essentially the same for games as for entertainment videos: these alternatives are poor competitive substitutes for DVDs. We discuss streaming, downloading and brick-and-mortar kiosks in turn.

1. Streaming

The term "video streaming" refers to the distribution of content that is stored by the distributor on its own system of servers (a/k/a the "cloud"), and downloaded in parts to the consumer over the Internet. Video streaming is best known for the distribution of pay-per-view movies, and for video websites such as www.youtube.com. For video games, streaming has several serious and unsolved drawbacks. Hodess Decl. ¶ 21.

First, the consumer must buy and install expensive and specialized equipment, including the interface and controller devices needed to connect a TV set to the Internet and input the user's commands to the central processing unit. Hodess Decl. ¶ 22.

Second, the consumer must have a high speed broadband Internet connection to work at all, and the quality of the experience offered via streaming is dependent on the quality of the connection. Hodess Decl. ¶ 23.

Third, streaming is ill-suited at handling the large files commonly found in popular console games. Console games typically have sophisticated graphics and animation, requiring programs as large as 30-40 gigabytes. Moreover, a large portion of the file must be retrievable by the central processing unit at any time because of the interaction between the game and user. This requirement contrasts with movies, whose downloaded files can be stored in a buffer because only a relatively small portion of the total file must be played, in a relatively predictable sequence, at any given time. Existing internet systems, even with broadband service that is relatively fast and reliable, simply cannot retrieve and process the enormous quantities of data needed to keep up with the action of the game. The result is latency—i.e., a perceptible lag between a user's command and the response of the game on the display while the user's commands travel over the Internet to the host computer and the response returns to the user's equipment. Latency is a much more obvious and serious problem for streamed games than for DVD-and-console games, because data stored locally on a DVD or hard drive can be retrieved much more quickly in response to user interactions. Hodess Decl. ¶ 24.

Fourth, adapting a console game for streaming requires extensive recoding. Content owners are generally unwilling to incur the cost of this work without compensation from a third party. Hodess Decl. ¶ 25.

Fifth, unlike console games, which are protected by the First Sale Doctrine, PC games (whether for streaming or download) require a license from the publisher. Historically, publishers, to protect their retail revenues, have been reluctant to grant licenses for video game rental or subscription services. Hodess Decl. ¶ 26.

Sixth, using the protection of the First Sale Doctrine, GameFly sells used console video games after rental demand dissipates. This recovery of capital is critical to GameFly's economic model. There is no evidence that publishers have been willing to allow second-hand sales of streamed video games. This makes the streaming distribution model less attractive economically to both the consumer and GameFly. Hodess Decl. ¶ 27.

Because of these difficulties, GameFly has not entered the business of streaming console games over the Internet, and does not plan to do so. If, however, GameFly tried to enter that business, the company would need to invest hundreds of millions of dollars and several years of time just to match the scale of GameFly's current business. In addition to the hardware, personnel and bandwidth expenses that GameFly would incur, it also would have to arrange with game publishers for them to modify the games to make them compatible with the streaming model. GameFly would also have to write off most of its existing inventory of DVDs. The size of the potential market simply does not justify these investments. Hodess Decl. ¶ 28.

The track record of other firms that tried to stream video games confirms the infeasibility of this business model. OnLive invested approximately $500 million and several years of effort in building a nationwide system to distribute video games by streaming. The money ran out before the company managed to enter the market or sell itself to a larger company, and OnLive failed. Hodess Decl. ¶ 29; Ken Sweet, "Streaming video game site OnLive collapses and restructures," CNNMoney, http://money.cnn.com/2012/08/18/technology/onlive/index.html (August 18, 2012).

The streaming technology developed by Gaikai does not appear to have progressed past the demo stage. After massive investments in a network of data centers, the company's main achievement was to persuade Sony to acquire the business before Gaikai burned through its remaining cash. Despite Sony's resources, the post-acquisition company does not appear to have brought any product or service to the commercial market. Hodess Decl. ¶ 30.

Perhaps improvements in technology might make streaming a viable method of distributing console games one day. Now and for the foreseeable future, however, streaming is simply not a feasible method of distributing the large, complex, graphics-intensive console games that GameFly's subscribers seek. Hodess Decl. ¶ 31.

2. Downloading

Downloading differs from streaming in that the user downloads the entire file to his or her computer before beginning play: once play begins, the user's system retrieves the information from the user's local storage, not from the distributor's servers over the Internet. Downloading has some of the same problems as streaming, particularly the need for the consumer to acquire a TV interface and an expensive controller. Hodess Decl. ¶¶ 33-34.

Second, while latency is less of an issue for downloading than for streaming (because the entire file, once downloaded, is accessible on the user's local drive during play), the tradeoff is the lengthy waiting period required while the file downloads. A console game with a file size of eight gigabytes typically would take two hours to download—even if the size of the file did not crash the user's Internet connection. A game with a file size of 40 gigabytes would take about *eight hours* to download. Hodess Decl. ¶ 35.

Third, downloading games to a PC creates storage problems. The limited storage capacity of many PCs means that a consumer could download and save only a limited number of video games without the expense of external storage. Historically, consumers have also been reluctant to download games to their hard drives due to the difficulty and inconvenience of having to rebuild libraries after periodic hard drive failures. Hodess Decl. ¶ 36.

Fourth, many console games are unavailable in a PC format. Adapting a console game for downloading requires extensive recoding. Video game publishers have been unwilling to incur the cost of this work, placing the financial burden on would-be distributors. Hodess Decl. ¶ 37.

Fifth, unlike console games that are protected by the First Sale Doctrine, PC games (whether for streaming or download) require a license from the publisher. Historically, in order to protect their retail revenues publishers have been reluctant to grant licenses for video game rental or subscription services. Hodess Decl. ¶ 38.

Sixth, using the protection of the first sale doctrine, GameFly sells used console video games after rental demand dissipates. This recovery of capital is critical to GameFly's economic model. There is no evidence that publishers have been willing to allow second-hand sales of downloaded video games which makes the downloading distribution model less attractive economically to both the consumer and GameFly. Hodess Decl. ¶ 39.

For these reasons, the downloading of video games is not a viable competitive alternative to the distribution of rental games by DVD, and is unlikely to become a viable competitive alternative for the foreseeable future. Hodess Decl. ¶ 40.

3. Retail kiosks

As with Netflix, a Redbox-like network of automated self-service kiosks would not be a viable alternative distribution channel for GameFly. The capacity limits of a kiosk, and the diseconomies of decentralized distribution, are incompatible with the large product catalog that is one of GameFly's strongest selling points. Hodess Decl. ¶ 18.

GameFly learned this from painful first-hand experience. In 2009, GameFly launched a pilot project to test the distribution of game DVDs at automated retail kiosks. The company installed 22 kiosks in 7-Eleven stores, Barnes and Noble bookstores, college game rooms and military bases. The experiment was unsuccessful. An individual kiosk for a DVD rental business costs about $25,000, including inventory. Additional expenses of a kiosk include the cost of maintaining the kiosk and its automated equipment, stocking the kiosk with an inventory of DVDs, and paying the rent and utility costs charged by the owner of the facility where the kiosk is installed. The kiosks failed to generate enough revenue to cover these costs, and GameFly cancelled the project after 16 months. Hodess Decl. ¶ 17.

Redbox apparently agrees that the demand for video games is too small to support the costs of its business model. Although the Redbox has been offering video games for several years, video game rentals currently represent barely two percent of the company's rental volume. Outerwall Inc. Form 10Q for the period ended June 30, 2013 (filed July 25, 2013) at 34; Hodess Decl. ¶ 18.

4. GameFly would have to incur losses if the Postal Service raised the price of DVD mail.

For all of the above reasons, GameFly could not escape an increase in the postage charged for DVD mail by jettisoning mail for the Internet or building a nationwide network of self-service kiosks. GameFly would have to pay the price increases. Hodess Decl. ¶¶ 19, 32, 43.

This is not mere speculation. Before June 2011, when Order No. 718 eliminated the second-ounce charge for flat-shaped DVD mailer, GFL paid approximately 65 cents more per piece each way than Netflix. GameFly paid the extra postage not because it wanted to, but because it had no choice. GameFly's volume did not increase much after the price reduction took effect. GameFly does not expect its volume to increase much after the price is further reduced to 46 cents. And GameFly would not expect its volume to fall much if the price of DVD mail were raised substantially, unless the increase were large enough to force GameFly out of business. Postage is a cost of business that GameFly cannot escape, but must absorb. *Id*.

E. The Postal Service's Behavior

Another significant indicator of the presence or absence of market power is the behavior of the incumbent firm. While the Postal Service talks of effective competition, the Postal Service's actual conduct betrays a supplier with market power. It is "well established that the ability of a firm to price discriminate is an indicator of significant monopoly power." *Coal Exporters Ass'n*, *supra*, 745 F.2d at 91 (quoting antitrust treatises); F.M. Scherer, *Industrial Market Structure and Economic Performance* 459 (3d ed. 1990).

II. RECLASSIFYING ROUND TRIP DVD MAILERS AS A COMPETITIVE PRODUCT IS UNNECESSARY TO AVOID TRIGGERING A RECALCULATION OF AVAILABLE CPI PRICE CAP AUTHORITY.

The ostensible reason for the Postal Service's request to reclassify round-trip DVD mail as a competitive product is a concern that, if DVD mail remains classified as a market dominant product, reducing the current rate for flat-shaped DVD mailers to 46 cents might trigger a recalculation of available CPI price cap authority and require that any newly-generated unused authority be placed in the "CPI bank," which currently has a negative balance of 0.528 percent. USPS Request (July 26, 2013) at 4-6; USPS Motion for Reconsideration and Clarification (July 25, 2013) at 7-10. No such recalculation should be required, whether or not round-trip mail is regarded as market dominant. In Order No. 1807, however, the Commission confirmed that equalizing the price of letter- and flat-shaped DVD mailers while continuing to treat them as market-dominant First-Class Mail, will not require an immediate recalculation of available CPI pricing authority. Order No. 1807 at 7-10.

This ruling is correct. The Commission has repeatedly excluded temporary promotions and similar discounts from the calculation of percentage changes in rates. Order No. 1786 in Docket No. RM2013-2, *Review of the Commission's Price Cap Rules* (July 23, 2013) at 29. Nor did the Commission require such a recalculation when the Postal Service eliminated the second-ounce charge for flat-shaped DVD mailers in compliance with Order No. 718. On July 23, the Commission announced that it is opening a proceeding to consider generally the appropriate treatment of promotional discounts. Order No. 1786, Docket No. RM2013-2, *Review of Commission's Price Cap Rules* (July 23, 2013) at 28-33. The Commission reasonably declined to penalize the Postal Service for implementing a Commission-prescribed price reduction on a narrowly defined product while this aspect of the price cap rules remains unresolved.

III. MISCELLANEOUS ISSUES

A. The Commission Should Give No Weight To The Cost Estimates In Nonpublic Library Reference USPS-MC2013-57/NP1.

On August 5, 2013, the Postal Service filed under seal, in response to Commission Order No. 1794, estimates of the attributable costs of handling Netflix and GameFly DVD mail. Library Reference USPS-MC2013-57/NP1, *Nonpublic Material Provided in Response to Commission Order No. 1794*. The stated purpose of the analysis is to show that the proposed competitive mail product would cover its attributable costs and make the minimum contribution to institutional costs required by 39 U.S.C. § 3633(a).

The Commission should give the cost estimates no weight. First, because round-trip DVD mail faces too little competition to be reclassified as competitive under

39 U.S.C. § 3642(b), the cost coverage of DVD mail under 39 U.S.C. § 3633(a) is moot. Nor are the relative costs of letter-shaped and flat-shaped DVD mail relevant to any other material issue in this case. As the Commission recognized in Order No. 1763, cost differences between letter-shaped and flat-shaped DVD mail "cannot be relied upon to preclude complete relief from the undue discrimination the Commission has found to exist." Order No. 1763 at 32 (quoting *GameFly, Inc. v. PRC*, 704 F.3d 145, 148-49 (D.C. Cir. 2013)).

Further, if (contrary to fact) the cost data were material to any relevant legal issue on the case, giving any weight to the data would deny GameFly adequate notice and opportunity to be heard. GameFly has had only seven days to review the material, and no opportunity at all to subject it to discovery or cross-examination. As a result, the data necessarily remain largely untested.

Finally, and in any event, even the limited information disclosed by the Postal Service about data and assumptions underlying its cost estimates makes clear that they overstate the actual costs of handling GameFly DVD mail. For more detail, please see the separate Declaration of Sander Glick, which GameFly has filed under seal simultaneously with these comments.

B. The Mail Classification Schedule Should Be Changed To Prohibit Round-Trip DVD Mail From Being Sent As Generic First-Class Or Standard Letter Mail.

GameFly, in its August 1 Response to the Postal Service's July 25 Motion for Clarification of Order No. 1763, asked the Commission to "clarify that all DVD mailers, including Netflix, must mail their DVDs at the round-trip DVD rate." *Id*. at 14. The Postal Service, in its August 5 Response to Order No. 1794, agreed:

> [G]iven that an equalized rate remedy cannot be effective without Netflix's use of the Round-Trip Mail product, the Postal Service believes that Netflix should be required to mail its DVDs at the new round-trip DVD rate. , , , Accordingly, the Postal Service will draft conforming changes to the Domestic Mail Manual to ensure that all round-trip DVD mailers are required to utilize the new competitive product.

USPS Response to Order No. 1794 at 2 n. 4. Two days ago, however, the Commission stated without explanation that it is "not prepared to impose such a requirement" now. Order No. 1807 at 11. GameFly respectfully asks the Commission to reconsider this position. Allowing DVD rental companies to continue mailing DVDs as generic letters could nullify any remedy based solely on the equalization of rates for letter-shaped and flat-shaped pieces within the round-trip DVD mailer product.

The Mail Classification Schedule currently allows DVD rental companies to enter round-trip DVD mail as generic First-Class or Standard Mail letters rather than as "round-trip DVD mailers." The generic letter alternative has received little attention until now, for the obvious reason that the postage on a DVD mailed as a generic letter is the same as the postage on a DVD mailed as a round-trip DVD. The ability to mail DVDs as generic letters, however, would become a vehicle for renewed discrimination as soon as significant differences in price or quality emerged between "round-trip DVD mailers" and generic letter mail. If the round-trip DVD mail became costlier or lower in quality than generic letter mail, Netflix could migrate its mail to the generic letter category; the Postal Service could quietly give the resulting Netflix "letters" custom manual processing at no extra charge; GameFly, denied the manual processing needed to make letter mail service tolerable, could not follow suit; and discrimination that the Commission thought it eliminated in Order Nos. 1763, 1787 and 1794 would spring up anew. For GameFly, four-plus years of litigation would be for naught.

This is not just a theoretical risk. The round trip DVD mailer product that the Postal Service proposes to implement under Section 3642 is inferior in several respects to the existing letter mail product: unlike the existing round-trip DVD mailer product category within First-Class Mail, the proposed new DVD product would have no separate rate for single-piece mail; would not offer sealing against postal inspection (a nontrivial difference, given the rates of loss that DVDs suffer in transit through the postal system); and would have a maximum allowed mailpiece thickness of 0.25" (the current limit for a letter), down from 0.75" (the current limit for a flat) today (a nontrivial difference, given the importance of GameFly's cardboard protective insert in ensuring that its mailpieces are not carelessly entered into the automation letter mailstream). Most important, transfer of the round-trip DVD mail product to the competitive product list would remove all legal constraints on the maximum price of the product. The Postal Service could increase the price of a round-trip DVD mailer from $0.46 to $4.60 or even $460—as many multiples of the price of a generic letter as the Postal Service chose.

C. The Commission Should Maintain The Existing Definitions And Classification Requirements For DVD Mail Until The Postal Service Clarifies Precisely What Changes It Proposes, And Interested Parties Have An Adequate Opportunity To Comment.

The mailpiece design specifications and other classification terms of the proposed round trip DVD mailer product appear to have been cobbled together as an afterthought. The Postal Service states in its July 26 Request that "[a]ll service standards and processing elements [of the proposed round-trip DVD mailer product] would remain identical to the service currently received by First-Class Mail letters and flats." Request at 3; a*ccord*, *id*. at Attachment A, p. 8 ("Given that service standards will remain the same after the proposed transfer, customers' concern would likely be the effect of the modification on prices."). The actual Mail Classification Schedule language proposed by the Postal Service, however, contradicts these assurances. As noted above:

- The proposed product, unlike the existing DVD product, does not include separate MCS categories for letter- and flat-shaped pieces, and offers mailers no assurance that a mailpiece entered as flat will be processed as a flat. That is a crucial omission. As the Court of Appeals noted in *GameFly, Inc. v. PRC*, 704 F.3d 145, 148-149 (2013), flats processing is critical for GameFly to avoid the devastating effects of machine letter processing. Eliminating the right to receive flats processing would destroy the operational predicate of the price equalization remedy.

- The current rate schedule for both letter-shaped and flat-shaped round-trip DVD mailers includes a single-piece rate. The proposed MCS language contains only presort rates; no single-piece rate appears.

- The maximum allowed thickness of a mailpiece would be one-quarter inch, the same as the current thickness limit for letters. By contrast, the maximum allowed thickness of flat-shaped DVD mailers is currently three-quarters of an inch. This difference is crucial: GameFly has discovered that thickening mailpieces by stuffing them with a cardboard protective insert pays an important role in ensuring that mailpieces entered as flats are actually proceeded as automation flats, instead of being carelessly inducted into the automation letter mailstream.

- The proposed round trip DVD mailer product would not be sealed against inspection. *Cf*. 39 U.S.C. § 404(c) (requiring that First-Class Mail be sealed against inspection). This is not a trivial or harmless change, given the chronic losses of DVDs in the postal system.

It is unclear whether these discrepancies are intentional or inadvertent. Rather than speculate, however, the Commission should direct the Postal Service to clarify what it intends, and then give other interested parties an adequate opportunity to comment. In the meanwhile, the price reduction ordered by the Commission should take effect on September 30 as scheduled, and the MCS language prescribed in Appendix B to Order No. 718 should otherwise remain in effect.

Respectfully submitted,

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August 15, 2013

Attachment A

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

COMPLAINT OF GAMEFLY, INC.	)))	Docket No. C2009-1R
COMPETITIVE PRODUCT LIST ADDING ROUND-TRIP MAILER	)))	Docket No. MC2013-57
COMPETITIVE PRODUCT LIST ADDING ROUND-TRIP MAILER (MC2013-57)	)))	Docket No. CP2013-75

DECLARATION OF DAVID HODESS

(August 15, 2013)

My name is David Hodess. I am President and CEO of GameFly, Inc., with offices at 6080 Center Drive, Los Angeles, California 90045. I have held my present position since 2003.

Before joining GameFly, I was CEO and Founder of Cooking.com from 1998 to 2003, and Director, Business Development, at The Disney Store from 1995 to 1998. I received B.A. from Dartmouth College in 1984 and an M.B.A. from Harvard Business School in 1988.

I have been personally involved in GameFly's discrimination complaint against the Postal Service in Docket No. C2009-1 since the filing of the complaint in April 2009, and was actively involved in unsuccessful attempts to avoid litigation for two years before that. I testified in this case during a hearing on July 28, 2010.

I submit this declaration in response to some of the statements in the Postal Service's July 26 "Request Under Section 3642 to Create Round-Trip Mailer Product," and the accompanying "Statement of Supporting Justification" by Steven W. Monteith. In its filing, the Postal Service contends that maximum rate regulation of round-trip DVD mail is no longer necessary because two competing modes of content distribution—Internet streaming of electronic entertainment content and retail kiosks for renting DVDs—effectively constrain the Postal Service from raising the price of DVD mail above competitive levels.

The Postal Service (and Mr. Monteith) focus their discussion almost entirely on filmed entertainment (movies and television) of the kind offered by Netflix, and essentially ignore video games, the separate market in which GameFly operates. The purpose of this Declaration is to discuss the latter market. For the reasons explained below, the Postal Service still has market dominance over the delivery of video game DVDs by mail.

- **GameFly's Business**

GameFly, as the Commission knows, rents and sells video games by mail. The company has grown to become the largest online video game rental subscription service in the United States. GameFly's core business model is similar to that of Netflix's DVD rental business: for a monthly fee, a customer is entitled to rent one (or more) video game DVD(s) for as long or short as he or she wants, and receive a new video game upon returning the old one. A customer who wants to keep a video game permanently after playing it may buy it from GameFly.

GameFly's catalog includes more than 8,000 console video game titles, both newly released and classic. These titles include releases compatible with every major video game console system (including Xbox 360, PS3, PS Vita, Wii U, Wii, 3DS, and older systems). We plan to add titles for the Xbox One and PS4 as soon as they are released later this year. We purchase nearly every new title upon its initial release in the United States. In addition, we continue to carry in our inventory approximately 95 percent of all console video game titles that have been released since GameFly was founded in 2002.

Our average subscriber rents over 20 video games per year from us. Although we do have a secondary business selling downloadable games for the PC and Mac platforms, over 95% percent of our annual revenues come from the subscription rental and sales of console video games.

GameFly serves its subscribers from distribution centers in Pittsburgh, Tampa, Austin, Kansas City, Seattle and Lakewood (CA). Both outbound (distribution center-to-subscriber) and return (subscriber-to-distribution center) shipments move by First-Class

Mail. GameFly pays the postage on the return shipments through Business Reply Mail accounts with the Postal Service.

GameFly relies exclusively on the Postal Service for product distribution. This is because no cost-effective alternative method of product distribution exists. If the Postal Service were to raise its price for DVD mail, GameFly would have to pay the higher price. In the remainder of this Declaration, I discuss in turn intramodal competition (i.e., competition from private carriers such as UPS and FedEx), intermodal competition (i.e., competition from retail outlets, which require the consumer to drive to the retailer instead of having the product delivered to the consumer's residence) and product competition (streaming or downloading over the Internet).

- **Intramodal Competition For Door-to-Door Delivery of DVDs Does Not Exist.**

As the Postal Service acknowledged in its July 26 filing, neither UPS nor FedEx offers a competitive delivery service: "the Postal Service does not know of another shipping company that provides door-to-door delivery of optical disks such as DVDs (DVD-by-mail) . . ." Monteith Statement, p. 9

- **Intermodal Competition (A Network Of Self-Pickup Retail Kiosks) Is Unsuited For GameFly's Business Model.**

A second potential form of competition for DVD-by-mail is the retail rental outlet: instead of the DVD traveling to the customer, the customer travels to the DVD. Blockbuster began as a version of this model. Redbox, which operates a chain of retail kiosks inside grocery stores and other retail facilities, is another example. Monteith Statement, p. 8. The Postal Service's theory apparently is that, if the price of postage on DVDs-by-mail becomes too high, GameFly will be forced to raise its subscription prices to consumers, and consumers will start renting their video game DVDs at retail rental outlets instead.

However, retail distribution has a serious disadvantage vis-à-vis DVDs-by-mail: large diseconomies of scale make retail distribution more expensive. Distributing a given volume of merchandise from a single large distribution facility costs much less than distributing the same volume of merchandise from a multitude of smaller facilities. Real estate, labor, utility and equipment costs all have economies of scale.

Perhaps the biggest economy of scale involves the retailer's inventory. Demand for games differs by location in random and unpredictable ways. For example, on a given day one or more copies of the video game Madden 2013 could be sitting in a retail location in Minneapolis while the same game is out of stock in Atlanta. Extra inventory at one retail location may be inaccessible at another. Because an out-of-stock item can mean a lost sale, businesses typically maintain inventory levels that include a margin of safety above the average quantity that the retailer expects consumers to take during the period between restocking. The optimum amount of spare inventory reflects a tradeoff between the opportunity costs of the sales foregone when items are sold out, versus the costs of tying up working capital in additional inventory. The ratio of (1) the optimum amount of spare inventory to (2) the average volume turnover decreases as the average volume turnover increases. This relationship, a practical illustration of the law of large numbers (the tightening of confidence intervals around the estimated value as the number of observations increases), is a fundamental reality of inventory management. In this context, economies of scale in inventory mean that serving a given volume of demand with merchandise distributed throughout at a multitude of smaller retail facilities requires a firm to incur higher inventory costs than serving the same volume of demand with inventory stored at fewer but larger mail fulfillment centers.

Economies of scale have transformed retailing in recent decades. The dynamic is reflected in the decline of independent retailing at the hands of large national chains; the decline of the same independent retailers at the hands of Wal-Mart, which pioneered the use of giant regional warehouses; and the decline of brick-and-mortar bookstores and other retailers, large and small, at the hands of Internet retailers like Amazon.

The same phenomenon characterizes the movie DVD rental business. Blockbuster's national network of thousands of retail outlets, which once dominated the movie DVD rental business, was surpassed and eventually forced into bankruptcy by Netflix, which used a mail model with far fewer points of distribution. Blockbuster emerged from bankruptcy in 2011 as a subsidiary of Dish Network Corp. In a dramatic illustration of the power of scale economics demonstrated by Netflix, Blockbuster recently announced it would consolidate to 350 domestic retail locations, down from over 5000 at its peak.

The same principles apply to console video game rentals, as GameFly learned from first-hand experience. In 2009, GameFly launched a pilot project to test the rental of video game DVDs at automated retail kiosks. We installed 22 kiosks in 7-Eleven stores, Barnes and Noble bookstores, college game rooms and on US military bases. The experiment was unsuccessful. An individual kiosk for a DVD rental business costs approximately $25,000, including inventory. Additional expenses to operate a kiosk include the cost of maintaining the kiosk and its automated equipment, and the rent and utility costs charged by the owner of the facility where the kiosk is installed. Even in our pilot locations, which we selected for high traffic and favorable demographics, our kiosks failed to generate enough revenue to cover these costs, and we cancelled the project after 16 months.

The recent success of Redbox with kiosks does not teach a different lesson. Redbox controls its inventory costs by offering an extremely limited selection at any kiosk: approximately 200 titles, 85-90 percent of which are movies rather than games. While Redbox experience may have proven that movie-oriented kiosks have viable economics, the small proportion of video games and lack of video-game-only kiosks are further indications that kiosk-based rental of video games is not economically viable. To demonstrate further the challenges of kiosk-based rental, even Blockbuster's attempts to compete with Redbox in the movie kiosk market have been unsuccessful.

For these reasons, even a large increase in the prices charged by the Postal Service for DVD mail would not cause GameFly to switch its method of renting console games to a fundamentally uneconomic distribution strategy using kiosks. Our only option would be to pay the higher prices charged by the Postal Service.

- **Streaming And Downloading Of Video Games Over The Internet Do Not Provide Effective Competition For Distribution Of Game DVDs By Mail.**

The Postal Service also asserts that the mail delivery of rental DVDs also faces effective competition from "online streaming and/or download services." Monteith Statement at 4. This claim is untrue for the console video games that GameFly offers.

- **Streaming**

The term "video streaming" refers to the distribution of content that is maintained by a distributor on a system of servers and distributed in parts to the consumer over the Internet. Video streaming is best known for the distribution of pay-per-view movies and for video websites such as www.youtube.com. For console video games, streaming has several serious and unsolved drawbacks.

First, one of the main attributes of console video gaming is the ability to play on a large television monitor using console game controllers. Streaming video games directly to a television is not a service that is commercially available. While it is technically possible to stream to and play a video game on a television by linking a PC via an HDMI (or other video) connection, the consumer would be required to possess a sufficiently powerful PC to play the video game and to buy and install a specialized wireless controller.

Second, the consumer must have a high-speed broadband Internet connection to work at all, and the quality of the experience offered via streaming depends on the quality of the connection.

Third, streaming is ill-suited at handling the large files commonly found in popular console games. Console video games typically have sophisticated graphics and animation, requiring as many as forty gigabytes of data. Moreover, a large portion of the file must be retrievable by the central processing unit at any time because of the interaction between the game and user. This requirement contrasts with movies, whose downloaded files can be stored in a buffer because a relatively small portion of the total file must be played, in a relatively predictable sequence, at any given time. Existing internet technology, even with broadband service that is relatively fast and reliable, simply cannot retrieve and process the enormous quantities of data needed to keep up with the action of the game. The result is latency—i.e., a perceptible lag between a user's command and the response of the game on the display while the user's commands travel over the Internet to the host computer and the response returns to the user's equipment. Latency is a much more obvious and serious problem for streamed video games than for DVD-based video games, because data stored locally can be retrieved much more quickly in response to user interactions.

Fourth, many console video games are not available in a PC format. Adapting a game for streaming requires extensive recoding. Video game publishers have been unwilling to incur the cost of this work, placing the financial burden on would-be distributors like GameFly.

Fifth, unlike console games, which are protected by the First Sale Doctrine, PC games (whether for streaming or download) require a license from the publisher. Historically, publishers, to protect their retail revenues, have been reluctant to grant licenses for video game rental or subscription services.

Sixth, using the protection of the First Sale Doctrine, GameFly sells used console video games after rental demand dissipates. This recovery of capital is critical to GameFly's economic model. Publishers have also been unwilling to license second-hand sales of streamed video games. This makes the streaming distribution model less attractive economically to both the consumer and GameFly.

Because of these constraints, streaming console video games over the Internet is not a substitute for DVD-based console video game rental, and GameFly has no plans to pursue this strategy. If, however, GameFly tried to enter that business, doing so would require investing hundreds of millions of dollars and several years of time to reach the scale of GameFly's current business. In addition to the hardware, personnel and bandwidth expenses that the company would incur, the company would have to enter into license agreements with the game publishers and modify the video games to make them compatible with the streaming model. The size of the potential market simply does not justify those investments.

The track record of OnLive, a company that tried to stream video games confirms the infeasibility of this business model. OnLive reportedly invested over $500 million and several years of effort in building a nationwide system to distribute video games by streaming. Due to technology challenges, high capital intensity, limited publisher support and lack of consumer interest, OnLive became insolvent and was reorganized in an assignment for the benefit of creditors in 2012. There was so little interest in OnLive's streaming business model that its assets were sold for only $5 million.

Founded in 2008, Gaikai also developed a video game streaming technology that was designed to stream short PC game demonstrations in order to stimulate subsequent purchase by download. Before commercializing the technology and determining whether a market exists, Sony acquired the company in 2012. Despite Sony's resources, however, the post-acquisition company has not brought any product or service to the commercial market.

It is possible that improvements in technology might make streaming a viable method of distributing console video games for rental one day. Now and for the foreseeable future, however, streaming is simply not a feasible substitute for renting DVD-based console video games.

For these reasons, an increase in the postage charged for DVD mailers would not cause GameFly to switch to internet streaming as a distribution method in lieu of mailing DVDs. GameFly would have to pay the postage price increases.

- **Downloading**

Downloading differs from streaming in that the user must download the entire file to his or her computer before beginning play; once play begins, the user's system retrieves the information from the user's hard drive or other local storage, not from the distributor's servers over the Internet. Downloading has many of the same problems as streaming, and others unique to its technology.

First, one of the main attributes of console video gaming is the ability to play on a large television monitor using standard game controllers. Downloading video games directly to a television is not a service that is commercially available. While it is technically possible to download to and play a video game on a television by linking a PC via an HDMI (or other video) connection, the consumer would be required to (a) possess a sufficiently powerful PC to play the video game and (b) buy and install a specialized wireless controller.

Second, the download times for large video game files can be quite lengthy. A 40-gigabyte game would take more than eight hours to download over an average household internet connection. Long download times like these make this distribution method extremely unattractive to consumers.

Third, downloading video games to a PC creates storage problems. The limited storage capacity of many PCs means that a consumer could download and save only a limited number of video games without the expense of external storage. Historically, consumers have also been reluctant to download games to their hard drives due to the hassle associated with having to rebuild libraries after periodic hard drive failures.

Fourth, many console video games are not available in a PC format. Adapting a console video game for downloading requires extensive recoding. Video game publishers have been unwilling to incur the cost of this work, placing the financial burden on would-be distributors.

Fifth, unlike console video games that are protected by the First Sale Doctrine, PC video games (whether for streaming or download) require a license from the publisher. To protect their retail revenues, publishers have been reluctant to grant licenses for video game rental or subscription services.

Sixth, using the protection of the first sale doctrine, GameFly sells used console video games after rental demand dissipates. This recovery of capital is critical to GameFly's economic model. Publishers have been unwilling to license second-hand sales of downloaded video games. This makes the downloading distribution model less attractive economically to both the consumer and GameFly.

Because of these constraints, downloading console video games over the Internet is not a substitute for DVD-based console video game rental, and GameFly has no plans to pursue this strategy. In addition to the hardware, personnel and bandwidth expenses that GameFly would incur, the company would have to negotiate license agreements with the game publishers and modify the games to make them compatible with the downloading model. The size of the potential market simply does not justify those investments.

GameFly currently operates a retail PC video game download business. The fact that the revenue associated with this business is less than five percent of our DVD-based rental and sales business reinforces the much lower attractiveness of this distribution strategy to consumers.

It is possible that improvements in technology might make downloading a viable method of distributing console video games for rental one day. Now and for the foreseeable future, however, downloading is simply not a feasible substitute for renting DVD-based console video games.

For these reasons, an increase in the postage charged for DVD mailers would not cause GameFly to switch to Internet downloading as a distribution method in lieu of mailing DVDs. GameFly would have to pay the postage price increases.

Further declarant sayeth not.

VERIFICATION

I declare under penalty of perjury that the foregoing is true and correct. Executed on August 14, 2013.

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