

UNITED STATES OF AMERICA
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

Before Commissioners:

Ruth Y. Goldway, Chairman;
Robert G. Taub, Vice Chairman;
Mark Acton;
Tony Hammond; and
Nanci E. Langley

Competitive Product List
Adding Round-Trip Mailer

Docket No. MC2013-57

**ADDITIONAL COMMENTS OF NETFLIX, INC.
SUBMITTED PURSUANT TO ORDER NO. 1827**

(September 11, 2013)

Netflix, Inc. (Netflix) submits these Additional Comments in opposition to the Postal Service's Request to classify the proposed Round-Trip Mailer as a Competitive Product. These Comments address the following issues: First, the Commission should affirm in this docket its finding in Docket No. C2009-1R that it is premature to mandate that all DVD mailers must use the Round-Trip Mailer.¹ Second, the Round-Trip Mailer is covered by the postal monopoly and therefore cannot be classified as a Competitive Product under 39 U.S.C. § 3642(b)(2). Third, the purpose of the Competitive Product classification cannot be fulfilled because the Postal Service will not be able to set a rate

¹ Order No. 1828, Order Prescribing Remedy, Docket No. C2009-1R, September 4, 2013 (Order No. 1828) at 7-8.

for the Round-Trip Mailer that will maximize profits. Finally, certain erroneous statements by the Postal Service about the media industry must be corrected.

I. IN ORDER NO. 1828 THE COMMISSION PROPERLY DECLINED TO MANDATE THAT ALL DVD MAILERS MUST USE THE ROUND-TRIP MAILER, AND SUCH A MANDATE IS NOT WARRANTED IN THIS DOCKET.

GameFly has argued repeatedly that all round-trip DVD mailers should be forced to use the Round-Trip Mailer.² In Order No. 1807, the Commission declined to impose such a mandate.³ GameFly requested reconsideration of that decision and argued that if the Round-trip Mailer “became costlier or lower in quality than generic letter mail,” DVDs mailed at the generic letter rate could result in renewed discrimination.⁴ In Order No. 1828, the Commission explained that “[n]either of those conditions exists, nor is their emergence imminent,” and then concluded that “GameFly’s renewed request for clarification remains premature and is denied.”⁵ The Commission also noted that the “GameFly and Netflix comments on the potential for renewed discrimination remain before the Commission in Docket Nos. MC2013-57 and CP2013-75.”⁶ The Commission

² Response of GameFly, Inc. to USPS Motion for Reconsideration and Clarification of Order No. 1763, Docket No. C2009-1R, August 2, 2013 (GameFly Response to Motion for Reconsideration) at 14; Comments of GameFly, Inc. on USPS Proposal to Reclassify DVD Mailers as Competitive Products, Docket No. 2013-57, August 15, 2013 (GameFly Comments) at 32-34; Response of GameFly, Inc. to Reply Comments of Netflix, Inc., Docket No. MC2013-57, August 29, 2013 (GameFly’s Response to Netflix’s Reply Comments) at 6.

³ Order No. 1807, Docket No. C2009-1R, Order on Reconsideration and Clarification, August 13, 2013 (Order No. 1807) at 11.

⁴ GameFly Comments at 33.

⁵ Order No. 1828 at 8.

⁶ The comments referred to include an extra-round filing by GameFly. In GameFly’s Response to Netflix’s Reply Comments, GameFly repeatedly mischaracterizes Netflix’s positions. For example, in Netflix’s discussion of changing operational processes since 2011, one of the illustrations Netflix provided was that “the Postal Service [may] determine[] at some point ... that special handling of return DVDs is not the best option.” Reply Comments of Netflix, Inc., Docket No. MC2013-57, August 22, 2013 (Netflix Reply Comments) at 3. GameFly latches

should not order such a mandate here in Docket No. MC2013-57, for two reasons: First, as the Commission has already found, a mandate is premature, and second, Netflix's future use of generic First-Class Mail, should it ever occur, would not result in renewed discrimination.

The rate for the Round-Trip Mailer is the same as the rate for a generic First-Class letter. The Postal Service has not proposed to increase it. If the Postal Service seeks to change this, GameFly will have an opportunity to comment.⁷

If, in the future, the Postal Service proposes to adjust rates for round-trip DVD mail, it will be required to file a notice of rate adjustment with the Commission. Under the Commission's rules, a notice of rate adjustment must include sufficient information to allow the Commission to determine whether the planned rates are consistent with the policies of title 39 Interested persons may also submit comments on whether the proposed rates conform with Commission orders.⁸

onto this sentence to argue the *non sequitur*. "[T]his is not the stuff of which reopening is made." GameFly's Response to Netflix's Reply Comments at 4. GameFly then argues for two pages against reopening the record, alluding to the "irreparable injury that GameFly has suffered, and continues to suffer." *Id.* at 5. But Netflix never requested reopening and in fact recognized that "[t]he Commission has already declined to reopen the record [because reopening] could result in further delay and injury to GameFly." Netflix Reply Comments at 4 n.10.

⁷ GameFly's interpretation of this quote is another example of it distorting Netflix's positions. Netflix had quoted this language from Order No. 1807 to support its position that "[n]o party—not even GameFly—will be harmed if the Commission refrains from issuing a mandate." Netflix Reply Comments at 4. In this passage, the Commission is clearly referring to a Price Adjustment proceeding under 39 C.F.R. Part 3010 that will provide GameFly an opportunity to comment. (The ellipsis portion of the quote contains a direct citation to 30 C.F.R. Part 3010.) But GameFly wrongly characterizes Netflix as having said that "if and when' the alternative option of using generic First-Class letter mail to send DVDs can be *exploited with discriminatory effect by the Postal Service and Netflix*, GameFly can raise its concerns with the Commission *then (id. at 4).*" GameFly Response to Netflix's Reply Comments at 5-6 (emphasis added).

⁸ Order No. 1807 at 11.

Issuing a mandate now is premature and would have the adverse effect of limiting the operational flexibility of the Postal Service and DVD mailers.⁹

But, even if the issue were not premature, a mandate would be unwarranted. GameFly's entire argument for the mandate is based on the assumption that, if the Round-Trip Mailer rate were higher than the generic First-Class letter rate, the Postal Service could then "*provide Netflix with manual handling, [and] allow Netflix to mail DVDs at a lower rate than GameFly.*" GameFly goes on to argue that "without access to the same level of manual processing, [it] would be relegated to the higher rate created specifically for DVDs."¹⁰ GameFly postulates that Netflix could "avoid the price increases by entering its DVDs as generic First-Class letters, *an alternative made feasible by ... special manual processing.*"¹¹

But GameFly's key assumption, that Netflix mail sent as generic First-Class letters would receive manual culling, is unsupported. Netflix has never maintained that it expects to receive manual culling for any future DVD mail entered as generic First-Class Mail. In fact, Netflix has expressly stated: "[I]f Netflix return mail meets all specifications and *can be automated like ordinary First-Class Mail letters*, then that mail could qualify without reservation for the ordinary First-Class rate."¹² The examples Netflix provided in that discussion involve circumstances where manual culling does not occur, i.e., where the Postal Service discontinues "special handling of return DVDs,"

⁹ Netflix Reply Comments at 3.

¹⁰ GameFly Response to USPS Motion for Reconsideration at 14. Notably, GameFly does not mention that it would still have available the Round-Trip Mailer rate, which is much lower than the flats rate GameFly paid under Order No. 718.

¹¹ GameFly Response to Netflix's Reply Comments at 6 (emphasis added).

¹² Netflix Reply Comments at 3-4 (emphasis added).

and where Netflix considers using Full Service IMb© scans, which are taken during automated processing.¹³ If Netflix pieces “can be automated like ordinary First-Class Mail letters,” i.e., without special handling, there would be no discrimination against GameFly in Netflix’s use of the generic First-Class letter category.

Not only is a mandate unwarranted, but it is also questionable whether the Commission could issue the mandate in this docket without confronting separate questions of discrimination under the Filed Rate Doctrine or contravening its own procedural rules. If the Postal Service were to adopt the mandate urged by GameFly (that DVD mailers **must** use the Competitive Product Round-Trip Mailer), it would in effect be banning those mailers from using the established First-Class Mail categories as they are offered to the nation under title 39. Section 1100.1a of the Mail Classification Schedule (MCS) clearly states: “Any matter eligible for mailing ...^[14] may, at the option of the mailer, be mailed by First-Class Mail service.” The condition that the mailpiece may not contain a round-trip DVD does not appear in the MCS language for First-Class Mail. Adding this condition would violate the Filed Rate Doctrine and constitute unlawful discrimination.¹⁵

¹³ *Id.* at 3.

¹⁴ Only Customized MarketMail may not be mailed First-Class. Customized MarketMail is composed of “nonrectangular or irregular-shaped [] Standard Mail ... pieces.” Domestic Mail Manual (DMM) 705.1.1.1. These pieces do not meet the “mailability” standards in DMM 601 (relating to piece dimensions, piece thickness, piece weight, rectangularity, and length-to-width aspect ratio). These characteristics can be assessed easily by observing the piece without opening it. “With the exception of restricted matter as described in [DMM] 601.8.0 [nonmailable and restricted articles and substances], *any mailable item may be mailed as First-Class Mail.*” DMM 233.2.1(emphasis added).

¹⁵ See Reply Post-Hearing Brief of GameFly, Inc., Docket No. C2009-1, November 18, 2010, at 70-72. “The filed rate doctrine is a necessary corollary of Section 403(c). Requiring a

The Filed Rate Doctrine is a common law rule which provides that any entity that is required to file tariffs governing rates and terms and conditions of service must adhere strictly to those tariffs. Thus, a regulated entity may not charge a rate other than the one on file with the appropriate federal regulatory authority, and non-price features are considered part of the rate.¹⁶ The Postal Service must first file a request to change the Mail Classification Schedule under a separate docket relating to the Market-Dominant First-Class Mail category.¹⁷ That docket would be the appropriate venue to address issues such as whether a mailer may be deprived of access to basic and fundamental First-Class offerings which include sealed against inspection,¹⁸ whether prohibiting a similarly situated mailer from using First-Class when its pieces can be automated like ordinary First-Class Mail constitutes undue discrimination,¹⁹ and whether

regulated monopoly to publish important terms and conditions of service in tariff or tariff-like form reduces the likelihood that illegal discrimination will flourish in secrecy.”

¹⁶ See *American Telephone & Telegraph Co. v. Central Office Telephone, Inc.*, 524 U.S. 214, 223 (1998) (“Any claim for excessive rates can be couched as a claim for inadequate services and vice versa”), cited in Order No. 718, Docket No. C2009-1, Order on Complaint, April 20, 2011, at Para. 4022.

¹⁷ See 39 C.F.R. § 3001.61 (describing “Rules Applicable to Request for Establishing or Changing the Mail Classification Schedule”); 39 C.F.R. § 3010.10 (describing “Rules for Rate Adjustment for Rates of General Applicability”). *But see* 39 C.F.R. § 3020.90 (describing rules for “Requests Initiated by the Postal Service to Change the Mail Classification Schedule,” but these rules apply only to “corrections”).

¹⁸ GameFly’s Response to Netflix’s Reply Comments asserts: “If Netflix is allowed to mail its DVDs in a mail product that is sealed against inspection, then all senders of round-trip DVD mail must be allowed to do likewise.” *Id.* at 3. GameFly misses the point—GameFly already has access to a category of mail that is sealed against inspection, i.e., First-Class Flats, just as mailers of magazines can pay the higher First-Class rate to obtain the sealed against inspection feature. But GameFly wants to close off any access by Netflix to the sealed against inspection feature by forcing Netflix to use the Competitive Product and preventing Netflix from ever returning to generic First-Class letters, even when there is no potential for discrimination.

¹⁹ *Cf.* Post-Hearing Brief of GameFly, Inc., Docket No. C2009-1, November 8, 2010 (GameFly Brief) at 58-60, citing Red Tag Proceeding, PRC Op. & Rec. Decis., Docket No. MC79-3, (May 16, 1980), in which the Commission found undue discrimination where “the service was offered only to a select group of mailers arbitrarily selected from the broader group [T]he Commission recognized the fundamental principle that services can only be

the Postal Service can impose conditions based on content on First-Class letters that are sealed against inspection.²⁰ In any event, the Postal Service may not modify the terms and conditions for First-Class Mail through a mandate in this Competitive Product docket.

II. THE ROUND-TRIP MAILER, AS DESCRIBED BY THE POSTAL SERVICE, IS COVERED BY THE POSTAL MONOPOLY AND THUS MAY NOT BE CLASSIFIED AS A COMPETITIVE PRODUCT UNDER 39 U.S.C. § 3642(b)(2).

Section 3642(b)(2) of title 39 precludes a transfer from the Market-Dominant category of any product covered by the postal monopoly under the Private Express Statutes,²¹ which provide that only the Postal Service may carry a “letter” on a post route.²² A “letter” is a “*message* directed to a specific person or address and recorded in or on a tangible object. Tangible objects used for letters include but are not limited to paper, ... *recording disks*, and magnetic tapes.”²³ A “message” is “any information or intelligence that can be recorded” by methods such as “the use of written or printed characters ... or orientations of magnetic particles in a manner having a predetermined significance.”²⁴ A straightforward reading of this language leads to the

considered nondiscriminatory if they are made available to all similarly situated parties.” GameFly Brief at 60.

²⁰ First-Class Mail fulfills the requirement of Section 404(c) that the Postal Service establish a class of mail that is sealed against inspection. As a general matter, because First-Class Mail is sealed against inspection and can be opened only pursuant to a warrant, it is questionable whether and how the Postal Service could impose content-based conditions on First-Class letters when it cannot open those mail pieces to check their contents.

²¹ The Private Express Statutes may be found at 18 U.S.C. §§ 1693–1696 and 39 U.S.C. §§ 601–606.

²² 39 CFR § 310.2.

²³ USPS Publication 542, Understanding the Private Express Statutes, at 2-1, at http://about.usps.com/publications/pub542/pub542_ch2_001.htm. See also 39 CFR § 310.1(a).

²⁴ 39 C.F.R. §§ 310.1 (a)(2) and (4).

conclusion that a “disk” is a “letter” that contains a “message,” i.e., content such as a movie, and as such falls under the postal monopoly.²⁵ But the USPS Request argues that “the optical disc is merchandise and not a letter, and is thereby exempt from the Private Express Statutes.”²⁶

Merchandise is defined as a “good to be bought and sold.”²⁷ While the delivery of a DVD in certain circumstances may be considered the delivery of “a good bought and sold” (for example, when a consumer buys a movie DVD from Amazon), the DVDs that Netflix sends are short-term rentals of movie content for its members to watch *and return*. Hence the title of the proposed product: the **Round-Trip** Mailer.

The Postal Service itself acknowledges that a Round-Trip Mailer delivers content when it defines the market for its product as “the provision of access to digitized entertainment *content* to consumers.”²⁸ The delivery of a hammer is the delivery of *merchandise* and does not fall under the prohibition of the Private Express Statutes; a

²⁵ That the Postal Service was given a monopoly over the delivery of messages with content is consistent with the original “basic function” of the Postal Service “to provide postal services to bind the Nation together through the personal, educational, literary and business correspondence of the people.” 39 U.S.C. § 101(a).

²⁶ Request of the USPS under Section 3642 to Create Round-Trip Mailer Product, Docket No. C2009-1R, July 26, 2013 (USPS Request), Attachment A at 5. The Postal Service has filed over a hundred pages in this case but only three pages are devoted to providing justification under 39 C.F.R. 3020.32(e) to “explain whether or not each product that is the subject of the request is covered by the postal monopoly as reserved to the Postal Service.” See also 39 U.S.C. § 3642(b)(2). Of those three pages, only one paragraph addresses the core question of whether the Private Express Statutes apply to DVD mail. The rest of the discussion relates to exceptions for invoices, documents or advertisements that accompany the delivery of the exempt item and are incidental thereto. USPS Request, Attachment A at 6-7.

²⁷ Oxford Dictionary, at http://oxforddictionaries.com/us/definition/american_english/merchandise.

²⁸ USPS Reply to Comments, Docket No. MC2013-57, August 22, 2013 (USPS Reply) at 5 (emphasis added). See also *id.* at 11 (emphasis added) (“the ‘relevant market’ is thus comprised not simply of services that provide access to digitized entertainment content to consumers ... but also services that provide *that content*”); *id.* at 12 (emphasis added) (referring to companies “offering interchangeable *content*”).

hammer is a physical object with no “message” or content. But the delivery of a DVD, if the Postal Service is correct, is the delivery of *content* which happens to be in a particular physical form. As such, the Private Express Statutes apply. The Postal Service cannot have it both ways.

As a back-up argument, the Postal Service argues that “even if the optical disc containing a movie or video game were considered to be a letter, the optical disc is specifically excluded ... by 39 C.F.R. 310.1(a)(7)(xii) as a ‘computer program recorded on media suitable for direct input.’”²⁹ The referenced subsection (a)(7) lists twelve “exceptions”³⁰ that “are not letters within the meaning of these regulations.” Subsection (xii) is one of those exceptions:

(xii) Computer programs recorded on media suitable for direct input. For the conditions under which the Private Express Statutes are suspended for data processing materials, see § 320.2

[The referenced § 320.2 provides] (a) “data processing” means electro-mechanical or electronic processing and includes the recording of data by electro-mechanical or electronic means for further processing; and (b) “data processing materials” means materials of all types that are sent exclusively for data processing and are ready for immediate data processing, but only if they are produced recurrently in the course of the normal business operations of the office originating them or receiving them back from the processing center.

The “computer programs” exception exempts “procedural materials” (similar to the suspension of data processing materials) but not “substantive information.”³¹ A

²⁹ USPS Request, Attachment A at 5.

³⁰ While “exception”, “suspension”, and “exemption” may be used as distinct technical terms, those distinctions are not relevant here, and “exception” is used in its ordinary, non-technical sense.

³¹ USPS Request, PES Advisory Opinion 85-3, Attachment C (PES Advisory Opinion) at 3.

movie DVD that provides substantive information (i.e., content) is very different from a computer program for processing data. The Postal Service's PES Advisory Opinion 85-3, which the Postal Service attached in support of its Request,³² specifically recognizes this distinction:

Section 310.1(a)(7)(xii) excludes from the definition of letter "computer programs recorded on media suitable for direct input." If by "software" you refer to **computer programs or similar procedural materials**, the carriage of such software is permitted without payment of postage in accordance with this exclusion. **The restrictions do apply, however, to other substantive information recorded on magnetic media** which is not otherwise subject to an exclusion."³³

The Postal Service argues that DVD mail is exempt from the Private Express Statutes because it is a computer program akin to "procedural materials" rather than "substantive information"; at the same time, it argues that the delivery of DVD mail is the delivery of "digitized entertainment *content*."

The flaws in the Postal Service's interpretation of subsection (xii) are magnified when other exceptions under subsection (a)(7) are examined:

(ix) **Photographic material** being sent by a person to a processor and processed photographic material being returned from the processor to the person sending the material for processing

³² Presumably, PES Advisory Opinion 85-3 is the strongest support that the Postal Service could find for its position. Public research of PES Advisory Opinions may be conducted only by making an appointment with the Postal Service Library to examine physical copies. The FOIA Electronic Reading Room announces that it makes available online the "material contained in the public reading room." See <http://about.usps.com/who-we-are/foia/readroom/welcome.htm>. The USPS website in turn announces: "The Postal Service maintains a public reading room in the Postal Service Library. The following material is available: ... All advisory opinions about the private express statutes issued under 39 CFR 310.6" See http://about.usps.com/handbooks/as353/as353c4_016.htm. Despite these announcements, online access to PES Advisory Opinions does not exist, and this was confirmed by personnel at the Postal Service Library.

³³ PES Advisory Opinion at 3.

(xi) **Sound recordings, films,** and packets of identical printed letters containing messages all or the overwhelming bulk of which are to be disseminated to the public. The “public” does not include individuals residing at the place of address; individuals employed by the organization doing business at the place of address (whether or not the actual place of employment is the place of address); individuals who are members of an organization, if an organization is located at the place of address; or other individuals who, individually or as members of a group, are reasonably identifiable to the sender.³⁴

First, it is obvious on its face that “sound recordings” and “films” and “photographic materials” must be considered distinct items from “computer programs” because a separate exception applies to each. A movie DVD is more akin to a “film,” a “sound recording,” or even “photographic materials” than it is to “computer programs or similar procedural materials.”³⁵ Second, these exceptions to the postal monopoly are narrowly prescribed; logically, if an item does not fall within the exception, then it must fall in the overall category of a “letter[] within the meaning of these regulations.”³⁶

- The exception for photographic materials (which could perhaps include DVDs) applies only if they are “being sent by a person to a processor” or returned from the processor. All other photographic materials must therefore be letters subject to the postal monopoly.
- Sound recordings and films (which definitely include DVDs) are exempt only if “all or the overwhelming bulk of [them] are to be disseminated to the public. The ‘public’ does not include individuals residing at the place of address” or “other individuals who ... are reasonably identifiable to the sender.” It follows that all

³⁴ 39 C.F.R. § 310.1(a)(7)(ix) and (xi)(emphasis added).

³⁵ Attachment C at 3.

³⁶ 39 C.F.R. § 310.1(a)(7).

other sound recordings and films, such as the DVDs sent by Netflix to identified individuals, must be letters subject to the postal monopoly.

Totally apart from the question whether the Postal Service has market power under 39 U.S.C. § 3642(b)(1), the Commission should find that the Postal Service has failed to demonstrate that the proposed Competitive Product meets the criterion of 39 U.S.C. § 3642(b)(2), and should deny its Request on that ground.

III. THE POSTAL SERVICE CANNOT SET RATES FOR THE PROPOSED PRODUCT IN A WAY THAT MAXIMIZES PROFITS, AND THUS THE PURPOSE OF THE COMPETITIVE PRODUCT CLASSIFICATION WILL BE FRUSTRATED.

In its initial Comments, Netflix pointed out difficulties in defining the Round-Trip Mailer as a “product” with “a distinct cost or market characteristic” under 39 U.S.C. § 102(6).³⁷ The Postal Service responded by quoting the Commission’s statement in Order No. 536 that the “definition is so broad that ‘almost any category of mail would qualify’”³⁸ and by noting that “it is not unprecedented for the Postal Service to ‘cobble’ together different products into a combined offering.”³⁹ The Postal Service then credited the Commission with having created the Round-Trip Mailer as part of the remedy in Docket No. C2009-1, and stated: “The only difference between the product proposed by the Commission and the product proposed by the Postal Service, is that the Postal

³⁷ Netflix Comments at 4-5.

³⁸ USPS Reply Comments at 3, *quoting* Order No. 536, Order Adopting Analytical Principles Regarding Workshare Discount Methodologies, Docket No. RM2009-2, September 14, 2010, at 22.

³⁹ USPS Reply Comments at 4.

Service wishes to classify the product as Competitive.”⁴⁰ However, this difference is crucial.

Aside from whether the Round-Trip Mailer meets the definition of a “product” in Section 102(6), there are strong policy reasons why it should not become a “competitive product”— The creation of competitive products in the 2006 Postal Accountability and Enhancement Act was intended to remove regulatory restraints for products already subject to the constraints of a competitive market *so that the Postal Service can set prices to maximize profits*. But the unusual hybrid nature of the Round-Trip Mailer prevents the Postal Service from pricing it rationally to make a profit.⁴¹ As demonstrated below, there is no way to maximize profits for the Round-Trip Mailer because it is an amalgamation of components with very different cost coverages for which Postal Service must set a single equalized rate.

Whether an increase in rates for a product will result in an increase in profits depends on two things: (1) own-price elasticity of demand and (2) cost coverage. If the cost coverage is high, as it is for the mail of Netflix, it is relatively easy for an elastic response to lead to lower profits, which explains the Postal Service’s concern that a price increase would reduce its profits.⁴² But if the cost coverage is low, and even more so if the cost coverage is below 100 percent, as it is for GameFly’s flats, a price

⁴⁰ *Id.*

⁴¹ The Postal Service recognizes that the purpose of classifying a product as competitive is to allow it to compete so that it can make a profit. See, e.g., USPS Reply at 9-10 and 21 (emphasis added) (the Postal Service “simply cannot raise the price of its round-trip DVD mailer above competitive levels without *losing money*”; if it “were to attempt to raise its price [demand would drop sufficiently] to reduce *profits* for...the Postal Service).

⁴² USPS Reply at 9-10.

increase is profitable at almost any elasticity. GameFly's concern that its elasticity is extremely low cements that profit opportunity.

This concept can be explained in mathematical terms. We know that profit (π) equals total revenue ($P * Q$, where P =Price and Q =Quantity) minus total cost ($Q * MC$, where MC =Marginal cost). If we consider the effect of a small increase in price on profits, using Δ for change, we have:

$$\Delta\pi = P \Delta Q + Q \Delta P - MC \Delta Q$$

We also know that the elasticity (e) equals the percentage change in quantity divided by the percentage change in price, which means for small changes:

$$\Delta Q = \frac{e \Delta P Q}{P}$$

This can be substituted into the first equation. If we assume that the elasticity is always negative, we can work with its absolute value ($|e|$). Rearranging slightly, we obtain:

$$\Delta\pi = Q \Delta P \left[1 - \frac{|e| (P - MC)}{P} \right]$$

Note that $(P - MC)/P$ is commonly referred to as the markup fraction. If it equals 0.65, for example, one would say that 65 percent of the price is markup. The markup fraction increases and decreases with the more common cost coverage. For a small price increase, Q is positive and ΔQ is negative. Therefore, if the change in profit is to be positive, the quantity in the brackets must be negative. For this quantity to be negative, the mathematical product of the absolute value of the elasticity and the markup fraction must be greater than 1.

The result is that if the elasticity (in absolute value) is low and the markup fraction is low (consistent with a low cost coverage), as is the case for GameFly, the effect on profit of the price increase will tend to be positive. But if the elasticity is high and the markup fraction is high, as is the case for Netflix, the effect on profit of the price increase will tend to be negative.

Thus, if the Postal Service could act in an economically efficient way to maximize its profits, it would increase GameFly's rates and decrease Netflix's rates. Yet, as required under Order No. 1763,⁴³ the Postal Service must charge an equalized rate, even if the product is classified as "competitive."⁴⁴ This frustrates the entire purpose of classifying this product as competitive. Accordingly, as a product created by Commission order to remedy discrimination through an equalized rate, "the most natural fit for this new product" is not "on the Competitive side,"⁴⁵ but on the regulated Market-Dominant side.⁴⁶

⁴³ Order No. 1763, Order on Remand, Docket No. C2009-1R (June 26, 2013).

⁴⁴ Virginia Mayes points out how obvious it is that the letters are "effectively subsidizing the flat-shaped pieces within the same category due to the application of a single price for both types of mail and their disparate costs." USPS Reply, Declaration of Virginia J. Mayes, Attachment B at 11.

⁴⁵ USPS Request at 3.

⁴⁶ The Postal Service argues that if the Round-Trip Mailer remains as a Market-Dominant product, it "would be forced to apply part of its price cap authority to the Round-Trip Mailer to avoid losses as the unit costs increase as a result of volume declines." USPS Reply Comments at 24-25 (footnote omitted).

This statement is inaccurate for two reasons: First, it does not necessarily follow that unit costs will increase as volume decreases. On the outgoing side, Netflix mail, which constitutes most of the volume, is handled along with all other Presort Automation mail. Except that its presort mix could be a little different from average (a factor recognized in the rates) and that it is highly drop-shipped (a factor not recognized in the rates), there is no reason for the costs of Netflix mail to be any different from the costs of the parent category (Presort Automation). Also, Netflix's volume is small relative to the overall volume of Presort Automation. The unit costs of operations that process Netflix's mail are determined by the

overall volume going through them, not by a decline in a small element of that volume. On the incoming side, even though Netflix's mail is heavier than average, the PRM costs developed by the Postal Service show that its mail processing costs are below average. The costs of Netflix mail could increase significantly and still be close to the average for its parent category. Second, even if the costs of Netflix's mail were to increase above the average level, the Postal Service would not in any case "be forced to apply part of its price cap authority to the Round-Trip Mailer to avoid losses." *Id.* The Postal Service has considerable flexibility to recover costs through myriad shifts in the mix of rates in each class.

The Postal Service goes on to argue that "[a]pplication of price cap authority to a product with declining volume would prevent the Postal Service from applying price cap authority to growing products, leading to inefficient business decisions and restricting the Postal Service's ability to increase revenue." USPS Reply at 25.

But the cap simply does not operate that way. Suppose the cap is 2 percent. The increase of 2 percent is applied to First-Class whether or not the Round-Trip Mailer is in First-Class. If the Round-Trip Mailer is in First-Class, then First-Class volume is larger than if it were not. The 2 percent simply applies to the larger volume. On its face, then, the Postal Service would be better off applying the 2 percent to the larger volume. Going further, suppose there are two categories, Category A (representing all other) and Category B (representing the Round-Trip Mailer). Suppose Category A is growing and Category B is declining, as hypothesized by the Postal Service. The result is a certain set of volumes in Year Two. If Category A is the only category in First-Class, then the cap of 2 percent applies directly to Category A. To be complete, assume Category B is not in First-Class and gets a 2-percent increase. But if both Category A and Category B are in First-Class, then the Postal Service has the option of giving a below-2-percent increase to Category B and an above-2-percent increase to Category A, and it will still meet the cap. For the same cost (which is determined by the volumes of the two categories), the Postal Service receives more revenue in this latter case (both Category A and Category B in First) than it did in the former case (Category A in First and Category B elsewhere). In effect, the Postal Service is better off having both categories in First-Class than having Category B elsewhere. It is definitely not "significantly harmed" by having Category B in First-Class.

IV. THE POSTAL SERVICE'S ERRONEOUS STATEMENTS ABOUT THE MEDIA INDUSTRY MUST BE CORRECTED.

In attempting to support its sweeping claim of competition in “the provision of access to digitized entertainment content to consumers,”⁴⁷ the Postal Service reveals a fundamental lack of understanding of the media industry.⁴⁸ Consider the following statement:

GameFly contends that differences in the content made available by Netflix for delivery through streaming and mail delivery suggests that streaming and physical delivery constitute different markets....However, differences in the content offered by Netflix through different delivery channels reflects *business and branding decisions by Netflix*, and not limitations on the capabilities of different delivery options.⁴⁹

Here, in the wave of a hand, the Postal Service dismisses well-established media industry practice and an entire body of law as nothing more than “business and branding decisions.” But these are not business and branding decisions made by Netflix; they are decisions made by copyright holders as to whether and how they will license their content. Moreover, these rights are treated differently under the law and in industry practice depending on whether they are in physical form, such as a DVD, or non-physical forms, such as cable, broadcast, or streaming. Thus, as Netflix previously explained, “due to industry-wide practices [and] the copyright principle known as the ‘first sale doctrine,’ the content available to consumers via DVD services frequently

⁴⁷ USPS Reply at 5.

⁴⁸ For example, the Postal Service makes claims well outside its area of expertise by attempting to define media markets in ways that run contrary to determinations made by agencies with jurisdiction over these issues, such as the Federal Communications Commission. See Netflix Comments at 7-8 (citing multiple orders of the Federal Communication Commission).

⁴⁹ USPS Reply at 12 n. 4 (emphasis added).

differs from what is available via Internet-delivered video services” or, indeed, any other form of electronic, non-physical distribution.⁵⁰

For example, copyright holders (i.e., movie and TV studios and networks) routinely engage in a practice known as “windowing,” whereby they reserve time periods or “windows” of exclusivity for different types of video delivery, such as theatrical distribution, home video, cable and broadcast distribution, and Internet delivered services. Similarly, the first sale doctrine impacts the availability of content via DVD, streaming, cable, and other forms of electronic distribution. The first sale doctrine defines the extent of protection for physical items such as DVDs or books that contain copyrighted material. If a copyright owner sells copyrighted material in a physical form, such as a book or a DVD, the owner retains no further licensing, royalty, or distribution rights over how the individual book or DVD is used after the sale.⁵¹ Thus, the first sale doctrine provides the legal basis for a library to lend out copies of books it has purchased, and for retailers such as Costco and Amazon to buy DVDs from copyright holders and sell them to consumers.

The fact that a DVD distributor may rent or sell a particular title, such as a movie or video game, does not give that DVD distributor the right to provide that same content to its customers via electronic means. Non-physical delivery rights to content constitute distinct rights that are licensed separately from DVD distribution and are the subject of complex licensing provisions. The copyright owner can enter into contractual arrangements to impose limitations on the use of its digital content by electronic

⁵⁰ Netflix Comments at 8.

⁵¹ Of course, sale of a single DVD does not authorize the buyer to make copies of the DVD.

distributors (such as exclusivity or release date). Or the copyright owner can simply refuse to license rights for its content to certain types of electronic distributors or refuse to license content for electronic distribution altogether.

Another disconcerting statement by the Postal Service is:

GameFly attempts to stack the deck in its favor by defining the relevant market in terms of its existing business model of delivering DVDs by mail. Certainly, in the short term, GameFly may find it difficult simply to abandon mail delivery. But it *can* shift its business model over the medium- and long-term GameFly is no more trapped with its existing model than it is a monopolist in the field of delivery access to digitized electronic content.⁵²

Netflix does not purport to speak about GameFly's particular business model, but it is well known in the industry that significant operational obstacles prevent DVD distributors from switching easily to another form of delivery. Netflix has both a streaming Internet TV network and a DVD distribution business, and each line of business requires separate operations and expertise with little overlap between them. Netflix employs hundreds of engineers to ensure the functionality of Internet video streams over a variety of broadband connections and compatibility with hundreds of types of electronic devices. At the same time, Netflix has a separate division employing personnel with expertise in mail processing and postal operations to ensure quick and smooth delivery of DVDs. To assert that a DVD distributor can simply "shift its business model" to adjust to the Postal Service prices reveals a complete lack of understanding of the media industry.

⁵² USPS Reply at 24 (emphasis in the original).

V. CONCLUSION

For the foregoing reasons, Netflix requests that the Commission (1) reaffirm its decision in Order No. 1828 not to mandate that all DVD mailers must use the proposed Round-Trip Mailer and (2) deny the Postal Service's Request to classify the Round-Trip Mailer as a Competitive Product. Netflix has presented grounds for denial of the Request which do not require the Commission to resolve whether the relevant market should be defined to include all "provi[ders] of access to digitized entertainment content to consumers."⁵³ An administrative decision on that specific issue could have far-reaching and possibly unintended consequences in industries outside the postal arena where the extent of competition in various digital markets is still hotly debated. Should the Commission choose to rule on this issue, however, Netflix respectfully requests that the Commission make clear that its decision is based on circumstances and considerations unique to the postal industry.

Respectfully submitted,

Joy M. Leong
The Leong Law Firm
2020 Pennsylvania Avenue, N.W., Suite 120
Washington, DC 20006
(202) 640-2590

Counsel for Netflix, Inc.

September 11, 2013

⁵³ USPS Reply at 5.