

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

COMPETITIVE PRODUCT LIST)
ADDING ROUND-TRIP MAILER) Docket No. MC2013-57

COMPETITIVE PRODUCT PRICES)
ROUND-TRIP MAILER (MC2013-57)) Docket No. CP2013-75

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

(September 18, 2013)

GameFly, Inc., respectfully submits these supplemental comments in response to one aspect of the September 11 comments of Netflix, Inc. GameFly obviously agrees with Netflix that the Commission should not approve the proposed round-trip DVD mailer as a competitive product under 39 U.S.C. § 3642(b)(1). Moreover, Section IV (pp. 17-19) of Netflix's comments provide a helpful explanation of additional reasons why DVD rental companies like Netflix and GameFly are not free to jettison their DVD-by-mail businesses for Internet distribution. Two of the arguments offered by Netflix, however, are adverse to GameFly. GameFly replies here to one of them.¹

¹ GameFly will not respond here to Section I (pp. 2-7) of Netflix's September 11 comments, which offer further arguments for allowing Netflix to mail DVDs as generic First-Class letter mail rather than the round-trip DVD mail product created specifically for DVDs. Although GameFly believes that these arguments are without merit, the Commission ruled in Order No. 1807 (at 11) and Order No. 1828 (at 8) that it will not

In Section III (pp. 12-16) of its comments, Netflix argues that DVD mail should not be reclassified as a competitive product because the rate equalization prescribed by the Commission in Order No. 1763 will prevent the Postal Service from “set[ting] prices to maximize profits.” Netflix at 13. The thrust of the argument is that (1) Section 3642(b)(1) allows a market-dominant product to be reclassified as competitive only if the product transfer will allow the Postal Service to engage in unconstrained profit-maximization; (2) the profit-maximizing markup over marginal cost varies with the customer’s price elasticity of demand; (3) Netflix DVD mail has a much higher markup over cost than GameFly DVD mail, and Netflix’s demand for DVD mail service is more price elastic than GameFly’s demand; and (4) the rate equalization prescribed by the Commission in Order No. 1763, by preventing the Postal Service from engaging in unconstrained profit maximization, thus renders Section 3642(b)(1) inapplicable. Netflix comments at 12-16.

GameFly hesitates to challenge an argument whose ostensible purpose is to support an outcome with which GameFly agrees—i.e., denial of the product transfer request. The logic of Netflix’s argument, however, is problematic. The equations offered by Netflix are a variant of the conventional economic demonstration that a firm can earn greater profits through price discrimination than with uniform prices. Cf. F. M. Scherer and David Ross, *Industrial Market Structure and Economic Performance* 489-491 (3d ed. 1990); Jean Tirole, *The Theory of Industrial Organization* 135-139 (1988).

consider the issue until the Postal Service proposes rate or classification changes that would cause “round-trip DVD mail [to] becom[e] costlier or lower in quality than generic letter mail.” See *also* Order No. 1828 at 7-8 (stating that “interested persons would have ample opportunity to address whether any future Postal Service rate adjustment proposals conform with Commission orders” or threaten to “become a vehicle for renewed discrimination”).

When enacting 39 U.S.C. § 3642(d)(1) in 2006, however, Congress chose not to exempt competitive products from 39 U.S.C. § 403(c), the statutory prohibition against undue or unreasonable discrimination and undue or unreasonable preferences among mailers. To read Section 3642(d)(1) as operative only when approval of a product transfer request would allow unconstrained profit maximization, including through price discrimination, would make Section 3642(d)(1) a nullity.

It is possible that Netflix's argument, while ostensibly offered against reclassifying DVD mail as a competitive product, may in fact be a back-door attempt to lay the foundation for relitigating the price equalization remedy prescribed by the Commission in Order No. 1763 and upheld in Order No. 1807. If so, the attempt founders on both legal and factual grounds.

First, the notion that differences between Netflix and GameFly in the cost of or elasticity of demand for their DVD mail service can justify differences in the prices charged by the Postal Service is foreclosed as a matter of law by *GameFly, Inc. v. PRC*, 704 F.3d 145 (D.C. Cir. 2013), and the Commission's own findings in Order Nos. 718, 1763 and 1807. *GameFly* held that cost and elasticity differences between the DVD mail service provided to each company could not justify price or service discrimination between the two companies because GameFly used flat-shaped mail in the first place only as a result of the Postal Service's discriminatory handling of DVD mailers entered as letters:

The unstated assumption of this explanation is that GameFly has a free choice in whether to use flats or letters. But the Commission's findings establish that the Postal Service's terms of service discrimination against GameFly, not GameFly's free choice, led to the companies' use of different mailers.

The Commission found that GameFly would switch to letter mail if the Postal Service would provide the same service on the same terms it provides to Netflix. The Postal Service refuses to do so. Without special manual processing like that afforded to Netflix, switching to letter mail could subject GameFly to an epidemic of cracked and shattered DVDs. *The Commission cannot justify the terms of service discrimination its remedy leaves in place (providing manual letter processing to Netflix but not to GameFly) based on the companies' use of different mailers when the use of different mailers is itself the product of the service discrimination.*

GameFly, 704 F.3d at 149 (emphasis added); accord, Order No. 1763 at 4, 15, 19, 29, 30-31; cf. Order No. 718 at ¶¶ 4084, 4137-4138 (finding that GameFly used flats only because the Postal Service refused to provide Netflix-comparable levels of manual processing to GameFly mailers entered as letters). No party filed a timely request for further appellate review of the Court of Appeals' holding (including by Netflix, which chose not to become a party in Docket No. C2009-1), and the court's holding may not be collaterally challenged now.

Second, and in any event, the argument assumes that Netflix DVD mail in fact has a higher cost coverage and more elastic demand than GameFly DVD mail. Netflix has offered no evidence for either assumption, and none exists in the record. For the reasons explained in the August 15 and September 12 declarations of GameFly witness Sander Glick, the Postal Service's available cost estimates for GameFly mail are too unreliable to support any inferences about the relative cost coverage of Netflix and GameFly mail.

The notion that Netflix's demand for DVD mail is elastic (let alone highly elastic) is belied by Netflix's own statements. Netflix's Form 10-K report for 2012 (Feb. 2013),

for example, admitted that "[c]hanges 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).

To the same effect are Netflix's statements in its September 11 comments that "significant operational obstacles prevent DVD distributors from switching easily to another form of delivery" and "[t]o 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." Netflix comments (Sept. 11, 2013) at 19. These are not the statements of a customer with a "high" elasticity of demand for mail service. *Cf. id.* at 15.

CONCLUSION

The Commission should dispose of Netflix's arguments as explained above.

Respectfully submitted,

A handwritten signature in black ink that reads "David M. Levy". The signature is written in a cursive, flowing style.

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