

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

**COMMENTS OF GAMEFLY, INC., ON
RESPONSES OF USPS AND NETFLIX TO
CHAIRMAN'S INFORMATION REQUESTS**

(March 21, 2014; refiled March 24, 2014)

Pursuant to Order No. 2011, GameFly, Inc., ("GameFly") respectfully submits these comments on the responses of the Postal Service and Netflix Inc. to Chairman's Information Requests Nos. 1 and 3.¹ The responses further underscore the Postal Service's failure to prove that it faces effective competition for the delivery of DVD mail.

(1)

The basic facts in this case are largely undisputed. The Postal Service seeks to have DVD mail reclassified under 39 U.S.C. § 3642 as effectively competitive—and therefore exempted from maximum rate regulation—merely

¹ Response of Netflix Inc. to Chairman's Information Request No. 3 (filed January 16, 2014); Response of the United States Postal Service to Chairman's Information Request No. 1 (filed January 17, 2014).

because *some* consumers obtain video game and filmed entertainment content via the Internet or DVDs rented from self-service kiosks rather than via rental DVDs shipped by mail.

This reasoning has two fundamental flaws. First, despite the advent of other channels for distributing digital entertainment content, many consumers still prefer to obtain video games, movies and television shows from rented DVDs. Likewise, DVD rental companies—including GameFly, Netflix and smaller firms—still have large inventories of DVDs to rent to these consumers. The only practical way to deliver most of these rental DVDs to consumers is by mail; and the only practical way for consumers to return the DVDs to the rental companies is by mail.²

Second, there is no evidence that the growth in the volume of video games and movies distributed by the Internet and other channels has constrained the price that the Postal Service can profitably charge for the DVD rental volume that continues to move by mail. That question depends on the price elasticity of demand for the mail service.³ The Postal Service has offered no evidence that the advent of alternative channels of delivery via the Internet

² GameFly comments (Aug. 15, 2013) at 4; GameFly Supp. Comments (September 12, 2013; refiled December 26, 2013) at 28-31, 33, 34-50; *id.*, Hodess Supp. Decl. at ¶¶ 3-5.

³ GameFly comments (Aug. 15, 2013) at 5-7; GameFly Supp. Comments (September 12, 2013; refiled December 26, 2013) at 6-10.

and Redbox has caused the demand for delivery of DVDs by mail to become more elastic—let alone sufficiently elastic to deter the USPS from raising the price of DVD mail.

This is a crucial omission, given the substantial evidence that the demand for DVD mail service is price inelastic. The elasticity data submitted by the Postal Service (and credited by the Commission) in R2013-11 show that, in product after product, even very great losses of volume to the Internet diversion have not made the residual demand for mail price elastic.⁴ Indeed, in the exigent rate case, Postal Service witness Thress testified that price elasticities of demand for mail have not changed relative to where they were in 2006 or 2007, despite the considerable loss of mail volume to the Internet.⁵

Moreover, a report of the Postal Service's Office of Inspector General in May 2013 reached the same conclusion. USPS OIG Report No. RARC-WP-13-008, *Analysis of Postal Price Elasticities* (May 1, 2013). The report found, *inter alia*, that:

⁴ See GameFly Comments (August 15, 2013) at 11-14; GameFly Supplemental Comments (September 12, 2013; refiled December 26, 2013) at 13-17, 31 (summarizing USPS elasticity estimates); Docket No. R2013-11, Order No. 1926 (December 24, 2013) at 157 (crediting USPS elasticity estimates as “best evidence of record”).

⁵ Transcript of November 19, 2013, hearing in R2013-11, Tr. 1/77-80 (Thress).

- “The demand for the postal products studied is price inelastic. *Price increases will increase revenues. . . .*”
- “The Great Recession and the availability of electronic alternatives clearly decreased the demand for the postal services examined in this report, as evidenced by a drastic decline in volume over the past 7 years. However, *neither the recession nor any other event since 2008 caused postal price elasticities to increase in any significant way. Postal price elasticities are not in flux. The demand for postal products remains price inelastic.*”
- “Price elasticities generally are higher when competitive alternatives are more readily available. *Since electronic alternatives to mail have become increasingly widespread in recent years, one might think that price elasticity estimates that use data from an earlier, less competitive era would understate the price elasticities of mailers today. Christensen Associates found, however, that including historical data (from the 1990s, for example) in the econometric demand analysis does not materially affect the estimates of price elasticities.*”

Id. at ii (emphasis added).

(2)

Nothing in the Postal Service’s January 17 response to Chairman’s Information Request No. 1 fills these material defects in the Postal Service’s

case. The Postal Service asserts that the “continuing decline in” the DVD volumes of Netflix and GameFly and the “17 percent decline in membership for [Netflix’s] domestic DVD segment between the third quarter of FY2012 and the third quarter of FY2013” are “significant developments in the digitized entertainment industry.” USPS responses to CHIR 1, Questions 1 and 4. These developments do not begin to prove what the Postal Service must prove under 39 U.S.C. § 3642: that (1) all (or virtually all) consumers now regard content available over the Internet or from Redbox as adequate substitutes for the content available from video games or video entertainment available by mail on rental DVDs,⁶ and (2) competition for the content on DVDs effectively constrains the prices charged by the Postal Service for *delivering* those DVDs to and from consumers.⁷

⁶ Cf. *FTC v. Whole Foods*, 548 F.3d 1028, 1039 (D.C. Cir. 2008); *FTC v. Staples, Inc.*, 970 F.Supp. 1066, 1078-79 (D.D.C. 1997).

⁷ Cf. *Coal Exporters Ass’n of United States v. United States*, 745 F.2d 76, 84-85, 93, 95, 99 (D.C. Cir. 1984); *General Chemical Corp. v. United States*, 817 F.2d 844, 854 (D.C. Cir. 1987). The Postal Service has tried to distinguish *Coal Exporters Association* on the supposed grounds that the “downstream’ competitors” of the railroads’ customers were “subject to a price cap,” and also “used the same delivery method—railroads.” USPS Comments (Sept. 23, 2013) at 19-20. These claims are untrue. The downstream competitors of the captive U.S. coal mines that the U.S. railroads invoked as supposed constraints on U.S. rail transportation rates were *foreign* coal suppliers based in “Australia, South Africa, Canada, Poland, and West Germany.” 745 F.2d at 83. No one suggested that these foreign sources of coal were subject to price cap regulation, and none of these foreign coal sources would have had any reason to use U.S. railroads to haul coal from these foreign sources to the relevant end markets, which were in “Western Europe and the Far East.” *Id.* at 83-85.

None of the data submitted by the USPS, GameFly or Netflix in response to the Chairman's Information Requests suggest that DVD-by-mail rental of video games, movies and TV shows will disappear as distinct product markets for the foreseeable future. All of the volume data indicate that, despite the growth of the Internet and Redbox self-service kiosks, large numbers of consumers will continue to demand DVD-by-mail rental of video games for the foreseeable future.⁸ Likewise, Netflix's DVD-by-mail rental business, while certainly mature, is highly profitable and likely to remain a significant part of Netflix's business for many years to come. Netflix's Form 10-K for calendar year 2013 (issued February 3, 2014) stated, for example, that

The number of memberships to our DVD-by-mail offering is declining, and we anticipate that this decline will continue. We believe, however, that the domestic DVD business will continue to generate significant contribution profit for our business.

Id. at 11. Likewise, the January 22, 2014, letter of Netflix's CEO to the company's shareholders stated:

6.9 million DVD members continue to value the tremendous selection we offer on DVD. Contribution profit was roughly stable at \$110 million. We expect \$98 million in contribution profit for Q1, which reflects the postal rate increase implemented this month and higher seasonal usage.

Id. at 6.

⁸ GameFly response to CHIR 2, Question 1 (January 17, 2014);

(3)

The Postal Service's related assertion that Netflix's shift in "spending away from its Domestic DVD segment to invest more in streaming . . . would seem to be in conflict with the notion asserted by Netflix and GameFly, that digitized entertainment content sent via the mail or the internet are not part of the same market" (USPS Response to CHIR 1, Question 4)" is nonsensical. What the Postal Service observes is a capital allocation decision. Even a firm that operates in multiple unrelated markets must allocate investment capital among the divisions and lines of business of the firm. Capital allocation decisions are rationally based on the projected risks and returns of each potential investment. That capital is allocated in this manner does not prove that the alternative investment projects are in the "same market."⁹ Even conglomerate firms, which do business in multiple unrelated markets, make the same kind of capital allocation decisions.¹⁰

⁹ See, e.g., Richard A. Brealey and Stewart C. Myers, *Principles of Corporate Finance* 105-109 (7th ed. 2003); Thomas E. Copeland and J. Fred Weston, *Financial Theory and Corporate Policy* 25-41, 46-65 (3d ed. 1988).

¹⁰ See, e.g., Berkshire Hathaway 2013 Annual Report at inside front cover, 14, 67, 104-105, 107-108, and Chairman's Letter at 6 (describing process of allocating capital among the multiple unrelated businesses owned by Berkshire Hathaway); Berkshire Hathaway Inc. Form 10-K for 2013 at 1, 23, 31 (same).

(4)

The Postal Service likewise gains nothing from its discussion of Blockbuster, L.L.C.¹¹ Blockbuster went bankrupt in 2010 because it relied primarily on a large network of retail stores to distribute retail DVDs to consumers, and could not compete with the lower-cost distribution model of Netflix, which did not use retail stores. GameFly Comments (August 15, 2013) at 14-15 n. 2; 19-20; Hodess Decl. ¶¶ 13-17. DISH Network, a publicly traded company that is the third-largest branded pay TV service provider, acquired most of the assets of Blockbuster in 2011. In December 2013, DISH closed “all of [Blockbuster’s] remaining company-owned domestic retail stores” and “the Blockbuster by-mail DVD service.” Dish Network Corp. Form 10-K for 2013 (February 21, 2014) at 1. The liquidation of an unsuccessful and primarily store-based DVD distribution business after its acquisition by a satellite dish operator with no expertise in the DVD-by-mail business model reveals nothing about the continued viability of the stand-alone DVD-by-mail rental businesses operated profitably by GameFly and Netflix.

(5)

As in past filings, the Postal Service also seizes upon recent press releases and other product announcements as supposed proof that Internet-delivered video games are about to become effective substitutes for the high

¹¹ USPS Response to CHIR 1, Question 6.

power console video games hitherto available only on CDs. USPS response to CHIR 1, Question 4 (discussing Valve “Steam Machine,” Sony GaiKai platform, and Microsoft Xbox Live Compute “cloud-based system”). The Postal Service has made no showing that all consumers (the relevant standard) or even most consumers regard these products as adequate substitutes for the console games available for rental from GameFly through DVD-by-mail distribution. GameFly explained in its previous comments why many consumers do not consider the video games available via the Internet and other alternative distribution channels to be adequate substitutes for the console video games available for rental on DVDs.¹² For the reasons explained in the attached declaration of David Hodess, these distinctions remain.

CONCLUSION

To justify exemption of DVD mail from maximum rate regulation under 39 U.S.C. § 3642, the Postal Service must show that (1) essentially all consumers now regard the video game and filmed entertainment content available from the Internet or Redbox as a good substitute for the content available from DVD-by-mail rental services, or (2) the demand for mail delivery of DVD mailers has become so price elastic that further increases in the rates of postage charged for DVD mail would be unprofitable. The Postal Service has made neither showing.

¹² GameFly comments (August 15, 2013) at 23-30; GameFly Supplemental Comments (September 12, 2013; refiled December 26, 2013) at 37-50 and Hodess Supp. Decl.

Instead, it has offered the litigation equivalent of vaporware—speculation that market conditions might change enough to provide effective competition someday in the future.

Perhaps effective substitutes for DVD-by-mail may develop someday. Perhaps someday the demand for mail delivery of DVD mailers will be demonstrably price elastic. The flaw in the USPS argument, however, is that “someday” is irrelevant under 39 U.S.C. § 3642. Exemption of a service from maximum rate regulation today requires proof that the regulated carrier faces effective competition *today*. *Coal Exporters Ass’n*, 745 F.2d 76, 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).

Respectfully submitted,

/s/

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DECLARATION OF DAVID HODESS

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DECLARATION OF DAVID HODESS

1. My name is David Hodess. I am President and CEO of GameFly, Inc., with offices at 6080 Center Drive, Los Angeles, California 90045. I testified in Docket No. C2009-1 in 2010, and submitted declarations in Docket Nos. MC2013-57, and CP2013-75 on August 15 and September 12, 2013.

2. I submit this declaration in response to the January 17, 2014, responses of the United States Postal Service to Chairman's Information Request No. 1.

3. As in previous filings, the Postal Service cites recent press releases and other product announcements as supposed proof that Internet-delivered video games are about to become effective substitutes for the high power console video games hitherto available only on DVDs. USPS response to CHIR 1, Question 4 (discussing Valve "Steam Machine," Sony GaiKai platform, and Microsoft Xbox Live Compute "cloud-based system"). The Postal Service has made no showing that even a minority of consumers regard these products as adequate substitutes for the console games

available for rental from GameFly through DVD-by-mail distribution. GameFly identified in its previous comments the fundamental structural limitations of the Internet and other alternative distribution channels console video game content.¹

4. For the reasons explained below, these structural limitations remain. As long as a significant number of consumers still prefer to rent game DVDs by mail, then the premise of the Postal Service's product transfer request collapses, because the only economically viable means of delivery between DVD rental companies and consumers is the Postal Service.

5. The foremost limitation in the transition to digital distribution of games is the network infrastructure, the technological foundation of all digital delivery. While United States broadband penetration has risen steadily, network capabilities still lag behind what is required to accommodate the demand of digital game delivery. Only 34 percent of United States households now enjoy download speeds of greater than 10 Mbps.² Moreover, several major ISP providers have announced plans to slow their deployment of fiber connections to the household.³

¹ GameFly comments (August 15, 2013) at 23-30; GameFly Supplemental Comments (September 12, 2013; refiled December 26, 2013) at 37-50 and Hodess Supp. Decl.

² Akamai, "[The State of the Internet,](#)" 3rd Quarter 2013 Report.

³ "I think though the point for us is that while there might be a couple of things on the fringe, going in and digging up backyards again and deploying fiber into a lot of new markets I don't think is in the cards. More and more things are going mobile. We have got a great footprint that we can concentrate on. I think there is [sic] opportunities to partner out of market with companies that are there versus us going in and deploying FiOS." Lowell McAdam, Chairman & CEO of Verizon Communications Inc., Transcript of *Verizon at UBS Global Media and Communications Conference*, Thomson Reuters StreetEvents (December 9, 2013) at 12 (available at http://www.verizon.com/investor/DocServlet?doc=ubs_conf_vz_transcript_2013.pdf). AT&T's U-verse all-fiber optic service is currently available in only one market (parts of

6. Even with a 10 Mbps connection, the substantial download sizes of current-generation games (typically 15 GB for 7th-generation AAA titles) will require 3-4 hours, assuming the connection is uninterrupted and no other traffic is present. As game developers learn to harness next-generation hardware capabilities, file sizes will grow even larger. For example, *Killzone: Shadow Fall*, a recently launched title for the Sony PlayStation 4, already has reached a file size of 39.7 GB, equivalent to more than 10 hours of downloading time.

7. Internet outages are a further problem. A 2012 study found that 43 percent of United States households that subscribed to broadband Internet service had experienced an internet outage at least once per month. Fully 17 percent of these households had experienced an internet outage at least once per week. 38 percent had called their ISP because of unusually low downstream speeds, and most issues remained unresolved (i.e. continued sporadic slow speeds).⁴

8. These problems are a substantial barrier to consumer acceptance of downloadable versions of console-size games. Paul Tassi, a journalist who covers the

the Austin TX metropolitan area), with no additional launch plans announced in the first quarter of 2014. AT&T Inc. 2013 Annual Report (Feb. 2014) at 3 (www.att.com/Investor/ATT_Annual/2013/downloads/ar2013_annual_report.pdf).

Hybrid fiber-copper U-verse service has speeds of only 45 Mbit/s, no better than with copper-wire cable modems, and requires special installation. See, e.g., http://en.wikipedia.org/wiki/AT%26T_U-verse; www.huffingtonpost.com/bruce-kushnick/att-uverse-copper_b_2522703.html. Furthermore, complaints about the speed and reliability of U-verse service in actual use are widespread. See www.consumeraffairs.com/internet/att_broadband.html.

⁴ Cisco, “Bandwidth Consumption and Broadband Reliability: Studying Speed, Performance, and Bandwidth Use in the Connected Home” (2012).

video game industry for Forbes, noted this problem in connection with the digital release last fall of *Grand Theft Auto 5*:

[D]igital downloads of games on consoles still have a long ways to go in terms of convenience, and why people are so adamant about wanting to keep their discs. In the case of GTA 5, the file size is just absolutely massive. For PlayStation 3, it's 36 GB of space needed. 17-18 GB will be taken up on your hard drive to play the game when all is said and done, but 36 GB are required initially to install the game, and that's what you'll be downloading all night.

This is a problem for many reasons. First and foremost, the fact that there's no day-before preload for GTA 5 in the US hamstring the convenience of this entire process. Therefore, depending on your internet connection speed, the game might not even be done by morning if you were planning on playing as early as possible. Second, if you're randomly disconnected from PSN [the PlayStation network] in the dead of night, you'll have to resume things the next day at who knows what percentage level of completion (as my PSN/internet drops out frequently, I can easily see this happening). This may also happen if the PSN servers crash with everyone trying to download such a massive file at once with no preload. Additionally, your PS3 might not have 36 GB of free space if it's an old model or full of other games and DLC. And lastly, if you live in the US where this "digital midnight launch" is taking place, you may have an ISP with bandwidth limits, meaning the download is a big bite out of your monthly allowance.⁵

9. Streaming gaming services, notably the upcoming PlayStation Now, require broadband Internet speed, unrestricted data plans, and connection reliability to an even greater extent. Streaming an HD game requires stability both upstream (for the player's control inputs to be transmitted to the server running the game) and

⁵ Paul Tassi, "You Can Download 'GTA 5' On PSN Monday Night, But It May Not Be Worth The Hassle," *Forbes* (September 15, 2013) (<http://www.forbes.com/sites/insertcoin/2013/09/15/you-can-download-gta-5-on-psn-monday-night-but-it-may-not-be-worth-the-hassle/>).

downstream (for the video feed). This means the limitations in quality-of-service and latency inherent in broadband networks offered by most providers—even high-speed plans—will prove an obstacle in the successful delivery of streaming game services.⁶ Indeed, the prevalence of high-latency, data-capped broadband services in Europe has caused Sony to delay its planned rollout date for the PlayStation Now in Europe until the first quarter of 2015 at the earliest.⁷

10. Internet Service Providers (“ISPs”), concerned about the explosive growth of streamed entertainment (upwards of 60% of peak downstream traffic is comprised of video streaming), are moving toward controlling data volume through data caps, traffic prioritization and metered pricing. Metered data plans are already common among ISPs in Europe and Canada. ISPs in the United States, including Time Warner, Comcast, and AT&T, have begun experimenting with data caps in the range of 150GB to 300GB per month. These caps threaten to impose real constraints on Internet streaming of video entertainment and games. Netflix HD streaming consumes about 3GB an hour; HD video game streaming requires similar data download rates. Even two hours per day of video game streaming—with no other use of Internet bandwidth for any other purpose—can quickly reach the 150 MB cap and enter the penalty rate zone.⁸

⁶ Most people who stream movies and other video content from Netflix or other video entertainment providers over the Internet have encountered the same kind of network bottlenecks. The usual symptom is an interruption of the video and the appearance of a “rebuffering” screen.

⁷ “Sony creates custom PS3 hardware for PlayStation Now”, *Eurogamer* (January 17, 2014) (retrieved Feb. 25, 2014).

⁸ Using 2.7 GB per hour as HD streaming gaming estimated bandwidth requirement, based on Netflix HD video usage (1.0 to 2.8 GB per hour) and OnLive consumer bandwidth reporting, estimated 2.9 GB per hour usage.

Lower data caps common in some areas, such as Cox internet's 50 GB capped plans, would preclude using HD streaming games or video for even a single hour per day without exceeding the cap and paying penalty rates.

11. Content availability is another constraint. As GameFly and Netflix have noted in previous comments, the distribution of digital content via downloading or streaming over the Internet is unprotected by the "first sale" doctrine of intellectual property, which allows DVD rental companies 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.⁹ Because the "first sale" doctrine is inapplicable to the offering of digital content over the Internet, content providers demand licensing fees that often exceed what Internet distributors of video games and video entertainment are willing to pay.¹⁰

12. The buying power of major retailers over game publishers exacerbates this problem. Major retail stores such as GameStop, Best Buy, and Wal-Mart account for the overwhelming majority of console game sales. These retailers negotiate with game publishers to obtain exclusive pre-order bonuses, in-store promotions, and other valuable marketing support. In addition, console makers also rely on retail stores to sell their hardware. Digital delivery of video games on the first day of their release risks damaging the game publishers' relationships with these crucial retail partners.

⁹ GameFly comments (August 15, 2013) at 16-17; Netflix comments (August 15, 2013) at 8 & n. 15.

¹⁰ *Id.*

13. For these reasons, game publishers have used digital downloading primarily to generate more revenue from back catalogue titles, and have avoided making most new game releases available digitally. Moreover, when new game titles are offered digitally, they are generally offered at full price and without digital exclusives. This makes the digital versions of the releases less competitive than the versions of the games released on DVDs, which typically include pre-order incentives, season passes for additional downloadable content (“DLC”), and other bonus content. Those publishers experimenting with digital delivery of select new game releases on next-generation consoles (i.e., Ubisoft, EA, and Activision) are offering no-frills versions at full price.

14. Indeed, Sony UK went one step further by selling digital copies of PlayStation 4 games at a *premium* over the retail price of DVD versions. When asked about this decision, Fergal Gara, the Managing Director of PlayStation UK, said, “we want to support a healthy retail channel, so it’s not in our interest to go and seriously undermine retail.”¹¹

15. Digital rights management (“DRM”) and security are also major issues with digital versions of games. Digital games, unlike even the no-frills disc-based versions of the same games, are explicit software licenses with associated limitations (i.e., no guarantee of continued access, availability, and services). In fact, some game companies have shuttered their online services out of financial necessity or convenience. Online multiplayer game shutdowns have comprised the bulk of shutdowns, but such shutdowns (a standard Electronic Arts practice for sports franchise

¹¹ “Sony explains PS4 digital game pricing,” *Eurogamer* (November 2013).

games after two years) and publisher bankruptcies (most recently, THQ) create concerns for consumers, who worry about losing access to purchased digital game content/services with little recourse. Furthermore, DRM measures have been known to limit owner access to their titles during the immediate launch of the product. While license-holders sell digital titles in good faith, the impermanence and uncertainty of access to downloaded and streamed games has limited the attractiveness of these distribution channels for consumers.

16. Additionally, Microsoft and Sony have struggled with maintaining secure servers and player accounts. Some 77 million Sony PlayStation network accounts had their information stolen in 2011, one of the largest security breaches in history.¹² Hackers are constantly employing new tactics to gain access to Xbox Live and Steam accounts as well. Hacking can cost players hundreds to thousands of dollars in digitally-bought games, as well as additional amounts from the unauthorized use of the credit cards used to buy those games.

17. Consumer preferences may be even more critical than industry limitations in shaping the future of downloadable and streaming game services. First, the physicality of a disc-based console game affords buyers certain desirable benefits not matched by a digital counterpart. The ability to collect and display a large collection of disc-based games that are available for immediate use on demand is a point of pride for many console gamers. Even consumers who regularly rotate their games with rentals and trade-ins often keep a core collection of favorite titles. These titles are implicitly

¹² "PlayStation data breach deemed in 'top 5 ever' - Business - CBC News". Cbc.ca. 2011-04-27 (retrieved April 29, 2011).

understood to remain functional software far into the future. Further, the standard hard drives of both the PS4 and Xbox One are only 500 GB—enough for only 10-15 next-generation games. Acquiring more games digitally requires lengthy file transfers and the purchase of additional hard drives, both of which undermine the idea of ownership and permanence.

18. Digital games are also less well suited to social play than are games on DVDs. Gaming, even single-player titles, is inherently a social activity; players share, discuss, and engage with fellow gamers both in-person and online. Digital software, unlike a disk, cannot readily be taken to play on a friend's console. Microsoft considered shared/lent game licenses as part of the digital initiatives for the Xbox One console, but massive consumer outcry over the always-online requirement forced Microsoft to abandon this idea.¹³ Even if future license agreements allow virtual lending, the inconvenient download challenges outlined earlier remain an obstacle for a smooth lending experience.

* * *

19. None of the press releases and news stories cited by the Postal Service in its January 17 response to CHIR 1, Question 4, refute these facts. I discuss in turn the Valve "Steam Machine," the Sony GaiKai platform, and the Microsoft Xbox Live Compute.

¹³ GameFly supplemental comments (Sept. 23, 2013; refiled December 26, 2013) at 44 & Hodess Supp. Decl. ¶ 24.

20. **Valve “Steam Machine.”** As previous noted, Valve is a game publisher that also operates the Steam PC game download service. Steam does not offer downloading to video game consoles. Hodess Supp. Decl. (September 12, 2013) at ¶¶ 28 and 30. Valve recently announced that it will be certifying third-party PCs with components that meet Valve’s minimum performance requirements for running a proprietary “Steam” operating system that Valve is marketing.¹⁴ The operating system is “still very much in beta” testing.¹⁵ So are the computers themselves.¹⁶ Although Valve plans to beta test its own Steam Machine prototype, “there will be only 300 boxes sent out to beta users,” and they are likely to cost significantly more than game consoles.¹⁷

21. **Sony GaiKai (PlayStation Now).** GaiKai, which Sony acquired in 2012, is a technology for streaming games. Hodess Supp. Decl. (September 12, 2013) at ¶ 17. In January 2014, Sony announced that Gaikai technology would be used to offer a cloud gaming service, dubbed PlayStation Now, for the Sony PlayStation 4 platform at some point in 2014. The technology is still only in beta testing, however,

¹⁴ “Valve Steam Machine preview” (Feb. 4, 2014) (available at <http://www.stuff.tv/steam-box/valve-steam-machine-preview/review>).

¹⁵ *Id.*

¹⁶ USPS Response to CHIR 1, Question 4 at n. 9.

¹⁷ Mike Williams, “How Much Will A Steam Box Cost You?” in US Gamer (<http://www.usgamer.net/articles/how-much-will-a-steam-box-cost-you>); “Valve Steam Machine preview” (Feb. 4, 2014) (available at <http://www.stuff.tv/steam-box/valve-steam-machine-preview/review>); Alex Roth, “Is the conquest of the living room designed to be a three-way fight once more?” in TechRadar (January 16, 2014) (<http://www.techradar.com/us/news/gaming/valve-steam-box-release-date-news-and-features-1127072/2#articleContent>).

and “details regarding PlayStation Now are thin.”¹⁸ Moreover, as reviewers have noted, “[q]uestions remain relating to latency, especially when it comes to multiplayer-focused titles, as well as any costs attached to using the service.”¹⁹ “The real difficulty [with PlayStation Now] lies where it always does with any kind of streaming service or digital catalog: latency. A blazingly fast internet connection will help, but the real point of contention is latency, from which fast speeds can still suffer. When discussing video games—a medium that requires instant, active input and instant in-game results—even the smallest drop of latency would render the experience unplayable.”²⁰

22. In addition, it appears unlikely that PlayStation Now will attract many third-party games that are less than two years old. A securities analyst who covers the video game industry explained this problem recently:

The problem of attracting compelling content is rooted in the conventional publishing business model. Publishers endeavor to come up with game franchises that spawn sequels, and in most cases, release sequels every two to three years. Thus, the natural lifecycle of a new game is typically two years. As a practical matter, this means that a paid subscription service like PlayStation Now can only attract games after their retail lifecycle has ended: should the service hope to gain access to games earlier than that time frame, it would be required to compensate the publisher of the game for lost catalog sales over the remainder of the two-year sell-through lifecycle.

¹⁸ James Plafke, ExtremeTech (January 7, 2014) (www.extremetech.com/gaming/174236-ces-2014-gaikai-becomes-playstation-now-streaming-games-to-just-about-everything).

¹⁹ Adam Rosenberg, “Sony Finally Puts its GaiKai Tech to Use in PlayStation Now Game Streaming,” Digital Trends (January 7, 2014) (<http://www.digitaltrends.com/gaming/playstation-now-uses-gaikai-tech-stream-games-summer-2014/#!zBtRv>).

²⁰ James Plafke, *supra*.

Because of this, PlayStation Now is unlikely to attract many games that are two years old or newer unless it can find gamers who are willing to pay a significant premium for early access to content less than two years old. We believe gamers will weigh the cost of a monthly subscription or a pay-as-you-go rental scheme against the value of the underlying content; therein lies the rub. Two-year-old games are typically widely available for \$20 or less—as an example, EA’s *Battlefield 3*, released in late 2011, is offered at GameStop for \$20 new and for \$10 used—meaning that gamers will pay only a small amount for access to a two-year-old title. We believe that publishers will seek 70% of PlayStation Now revenues, similar to the iTunes pricing model, and we think that publishers will have little interest in ‘renting’ a \$20 game for anything less than \$8 – 10. Thus, we think that the pricing of pay-as-you-go rental will be prohibitive, or in the alternative, the quality of the content available on a pay-as-you-go basis will be poor.²¹

23. **Microsoft Xbox Live Compute.** Microsoft’s “cloud-based system, Xbox Live Compute” (USPS Response to CHIR 1, Question 4 at n. 12) illustrates in a nutshell one of the biggest unresolved problems with cloud-based games. One of the “major fears about download-heavy consoles” is the problem of system slowdowns and crashes when “hundreds of thousands or even millions of gamers all try to download the game at once.”²² The challenges are two-fold: the downloadable portion of the game must be downloaded without a hitch, and the cloud of servers required to play the game must “actually work. . . . [F]rankly, there are few online-based multiplayer games that launch these days without some manner of connection issues.”²³

²¹ Wedbush Securities Equity Research, *Entertainment: Software* 64-65 (February 11, 2014).

²² Paul Tassi, “‘Titanfall’ Will Be the First Real Digital Test for Xbox One,” *Forbes* (March 10, 2014) (<http://www.forbes.com/sites/insertcoin/2014/03/10/titanfall-will-be-the-first-real-digital-test-for-xbox-one/>).

²³ *Id.*

24. The March 11 launch of *Titanfall*, a highly touted multi-player online-only game, exemplified this problem. “The first evening of Titanfall’s US launch was considered an acid test for the online-only game. Some game critics have held off scoring the game in reviews until its online performance can be assessed.”²⁴ The release did not go well. It was followed almost immediately by the crash of the entire Xbox Live service for many users:

Well, that didn’t last long.

It seemed like a smooth launch for Titanfall so far, but just hours after I published my review praising Microsoft and EA for a release free from technical hiccups, Xbox Live has gone down.

Though there’s no official confirmation that the outage is tied to the Titanfall launch, it would be a fairly obvious culprit as millions of players try to access the game on launch day. Titanfall relies heavily on Microsoft’s Azure cloud servers which were going to be used to ensure something like this didn’t happen, but it appears things have gone wrong, as many expected they might.

The service outage has lasted for the better part of an hour now, and Xbox Support says that service is “Limited” right now. “Unable to sign in to Xbox Live on Xbox One?” they say, “We’re on the case to get this issue fixed as soon as possible!”

I thought I was taking crazy pills as when I was unable to play Titanfall (because there’s no offline mode, naturally), I turned to boot up Hearthstone, which has just dropped its beta badge to go officially live as of today. Now it seems Battle.net is also down, and the result was me resetting my internet for about twenty minutes until I figured out what was going on. I’m not sure why Hearthstone would pick today of all days to go live, nor do I know what their issue is, though I assume it’s 100% unrelated to Microsoft’s plight.

²⁴ Mike Jackson, “Xbox Live recovers after connection woes threaten to spoil Titanfall US launch,” CVG (March 11, 2014) (www.computerandvideogames.com/453409/xbox-live-sign-in-issues-plague-titanfall-launch/).

This is the problem with launching a 100% online multiplayer title like Titanfall. A game with a campaign would at least have something for players to do as they waited for Live to return, but the entire game is locked behind the online wall.²⁵

“Sign-in problems were still reported after Microsoft claimed the issue had been resolved.”²⁶

25. Meanwhile, sales of the Xbox One system have been lagging far behind the Sony PlayStation 4.²⁷ Even a successful launch of the *Titanfall* game is unlikely to solve these problems:

Microsoft’s efforts to sell the Xbox One as more of a general entertainment device akin to Roku’s streaming players or Apple TV (AAPL) has left hard-core gamers skeptical of the company’s long-term commitment to their pastime, says Gartner (IT) analyst Brian Blau. A lower-resolution version of Titanfall will be available for the older-model Xbox 360 and Windows PCs by the end of March, perhaps limiting the game’s ability to sell Xbox Ones. Above all, the cost of the Xbox One remains a problem, [Michael]

²⁵ Paul Tasi, “Xbox Live Down on ‘Titanfall’ Launch Day,” *Forbes* (March 11, 2014) (<http://www.forbes.com/sites/insertcoin/2014/03/11/xbox-live-down-on-titanfall-launch-day/>); accord, Alan Ng, “Xbox One login problems with Xbox Live down” (March 11, 2014) (<http://www.product-reviews.net/2014/03/11/xbox-one-login-problems-with-xbox-live-down/>); Gareth Halfacree, “Xbox Live issues tarnish Titanfall launch” (March 12, 2014) (<http://www.expertreviews.co.uk/games/1306465/xbox-live-issues-tarnish-titanfall-launch>); ;

²⁶ Mike Jackson, *supra*. The distribution of popular TV shows through streaming has led to similar system crashes. See Andrew Sims, “‘True Detective’ crashes HBO GO,” *hypable* (March 9, 2014) (<http://www.hypable.com/2014/03/09/true-detective-crashes-hbo-go-password-sharing/>); “Ellen DeGeneres’ Oscars selfie goes viral, crashes Twitter,” *CBS News* (March 3, 2014) (<http://www.cbsnews.com/news/oscars-2014-ellen-degeneres-oscars-selfie-goes-viral-crashes-twitter/>).

²⁷ Dina Bass and Cliff Edwards, “Microsoft Hopes Titanfall’s Robots Can Save the Xbox One,” *BloombergBusinessweek* (March 6, 2014) at 37 (available at <http://www.businessweek.com/articles/2014-03-06/microsoft-hopes-titanfalls-robots-can-save-the-xbox-one>).

Pachter [an analyst at Wedbush Securities] says. “The competition this week is, let’s have exclusive content,” he says. “Next week the competition will be, how do we compete on price?”²⁸

26. This is not to say that the share of video game revenue generated by downloaded or streamed games cannot grow, or that the DVD-by-mail business model will last forever. All indications are, however, that a significant number of consumers will continue to want to rent video games on DVDs by mail for the foreseeable future. As long as a significant demand for DVD-by-mail rental video games remains, GameFly will need to use the mail to satisfy that demand, and the Postal Service will have market power.

27. Further declarant sayeth not.

²⁸ *Id.*

VERIFICATION

I declare under penalty of perjury that the foregoing is true and correct. Executed
on March 21, 2014.


