

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

Before Commissioners:

Ruth Y. Goldway, Chairman;  
Mark Acton, Vice Chairman;  
Robert G. Taub

Competitive Product List  
Adding Round-Trip Mailer

Docket No. MC2013-57

**REPLY COMMENTS OF NETFLIX, INC.  
SUBMITTED PURSUANT TO ORDER NO. 2011**

(April 4, 2014)

Netflix, Inc. (Netflix) submits these Reply Comments pursuant to Order No. 2011.<sup>1</sup> The primary question in this proceeding is *not* whether there is competition in the market for “access to digitized entertainment content.” Rather, it is *whether the Postal Service has shown that it lacks market power in pricing the Round-Trip Mailer product, i.e., the delivery of DVDs.* The Postal Service has not provided a credible

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<sup>1</sup> Order No. 2011, Order Establishing Comment Dates, Docket No. MC2013-57, March 7, 2014.

analysis of the elasticity<sup>2</sup> of the Round-Trip Mailer product and thus has failed to justify its Request<sup>3</sup> as required by 39 U.S.C. § 3642(1) and PRC Rule 3020.

Throughout this proceeding, the Postal Service has attempted to shift attention from the proposed Round-Trip Mailer product to the market for “access to digitized entertainment content.”<sup>4</sup> The Public Representative has characterized this effort as “a red herring [that] cannot substitute for actual analysis of markets and market power.”<sup>5</sup> In its latest submission, the Postal Service continues this misguided approach, arguing first that “the digital entertainment market is characterized by numerous competitors providing content through multiple distribution channels,”<sup>6</sup> and then that “the digital entertainment market is evolving rapidly.”<sup>7</sup> Netflix does not deny that there is considerable activity in the digital entertainment industry and that the technologies in it are “evolving rapidly.”<sup>8</sup>

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<sup>2</sup> PRC Rule 3020.32(d) requires the Postal Service to “verify” that it cannot set prices substantially above costs, raise prices significantly, decrease quality, or decrease output without losing a significant level of business. An elasticity analysis would quantify the sensitivity of mailers to price changes. Low elasticity would be an indicator of market power. As used in these Comments, an “elasticity analysis” refers to a study of price sensitivity, which is based on credible data and addresses the criteria in PRC Rule 3020.32(d)(1)-(4), using generally accepted quantitative measures.

<sup>3</sup> Request of the United States Postal Service under Section 3642 to Create Round-Trip Mailer Product, Docket No. C2009-1R, July 26, 2013 (USPS Request), docketed by the Commission as Dockets No. MC2013-57 and CP2013-75, Notice and Order on Request to Add Round-Trip Mailer Product to Competitive Product List, Order No. 1794, July 30, 2013.

<sup>4</sup> See, e.g., United States Postal Service Reply to Comments, Dockets No. MC2013-57 and CP2013-75, August 22, 2013, at 5.

<sup>5</sup> Comments of the Public Representative in Response to Order No. 2011, Dockets No. MC2013-57 and CP2013-75, March 21, 2014 (PR Comments), at 2.

<sup>6</sup> United States Postal Service Comments Addressing Responses to Chairman’s Information Request Nos. 1, 2, and 3, Dockets No. MC2013-57 and CP2013-75, March 21, 2014 (Postal Service Comments), at 2.

<sup>7</sup> *Id.* at 6.

<sup>8</sup> The Postal Service quotes the following from Netflix’s 2013 Form10-K, filed at the SEC on February 3, 2014 (after the January 16 filing of responses to Chairman’s Information Request No. 3):

But pointing to “robust”<sup>9</sup> competition in the market for digital entertainment, without more, does not lead to the conclusion that competition constrains the Postal Service in pricing its Round-Trip Mailer product. To prove the absence of market power in pricing the Round-Trip Mailer, the Postal Service must show more than the fact that some consumers are able to receive some entertainment content by streaming and other entertainment content by mail, or that there is an array of options for accessing digital entertainment. It must show that the Round-Trip Mailer meets the standards set forth in PRC Rule 3020.32 (d)(1)-(4).<sup>10</sup>

Specifically, PRC Rules 3020.30 - 3020.32 require the Postal Service to provide “all supporting justification” for a request to create a Competitive Product under 39 U.S.C. § 3642. Rule 3020.32 states that the Postal Service “shall” “(d) *Verify* that the change does not classify as competitive a *product* over which the Postal Service exercises sufficient market power that it can, without risk of losing a significant level of

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“The market for entertainment video is intensely competitive and subject to rapid change. Many consumers maintain simultaneous relationships with multiple entertainment video providers .... [Netflix's] principal competitors vary by geographic region and include multichannel video programming distributors [and] Internet-based movie and TV content providers, including ... DVD rental outlets and kiosk services and entertainment video retail stores.” Postal Service Comments at 3, *quoting* Netflix’s Form 10-K at 2. As already noted, the fact that Netflix faces competition does not necessarily lead to the conclusion that that competition constrains the Postal Service in pricing its Round-Trip Mailer product. Further, the “Form 10-K contains forward-looking statements within the meaning of the federal securities laws,” which are subject to “risks and uncertainties that could cause actual results and events to differ.” Netflix Form 10-K at 1. These risks and uncertainties are diverse ranging from earthquakes and computer viruses to the activities of competitors. The Form 10-K is hardly a quantitative study of the DVDs-by-mail product. Netflix’s Form 10-K for the fiscal year ended December 31, 2013, may be found at <http://www.sec.gov/edgar.shtml>.

<sup>9</sup> See Postal Service Comments at 2, 11. As noted previously, much of the Postal Service’s evidence for robust competition in the market for digital entertainment content is anecdotal or based on general industry reports and web articles. See Comments of Netflix, Inc. Submitted Pursuant to Order No. 2011, Docket No. MC2013-57, March 21, 2013, at 2, 6-7.

<sup>10</sup> In early comments in this docket, the Postal Service stated clearly that “*the relevant consideration for the Commission is whether [it] exercises sufficient market power that it can effectively set the price of [the Round-Trip Mailer] product substantially above costs ....*” United States Postal Service Response to Comments, Dockets No. C2009-1(R), MC2013-57, and CP2013-75, September 23, 2013, at 10 (latter brackets in original) (emphasis added). The Postal Service seems to have lost this focus.

business to other firms offering similar products: Set the price of such *product* substantially above costs (emphasis added).” Rule 3020.32(f) requires the Postal Service to “Provide a description of the availability and nature of enterprises in the private sector engaged in the delivery of the *product* (emphasis added).” The focus is entirely on the “*product*” to be created—here the Round-Trip Mailer product—not on a description of activity in the broader market.

A legally sufficient analysis of the Postal Service’s market power over this product would be expected to include a study of the elasticity the Round-Trip Mailer. An elasticity analysis would quantify mailer sensitivity to price changes. The availability of alternatives to the Round-Trip Mailer would be taken into account and quantified—not simply alleged or stated generally.

But, as the Public Representative notes, “the Postal Service has not provided: an elasticity for the Round Trip DVD product; a cross elasticity between DVD by mail products, streaming media products, and retail DVD rental products; or an explanation why the DVD mail market is not a captive market protected by the CPI cap.”<sup>11</sup> Nor has the Postal Service rebutted two facts already in the record which are solid indicators of the existence of market power under Rule 3020.32: (1) The current cost coverage of the Round-Trip Mailer, particularly the letter part, is high by any measure, certainly high enough to indicate substantial market power under Rule 3020.32 (d)(1);<sup>12</sup> and (2) “the

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<sup>11</sup> PR Comments at 2.

<sup>12</sup> See Comments of Netflix, Inc., Docket No. MC2013-57, August 15, 2013, at 5-6 (explaining that “competition tends to drive prices (usually down) toward marginal costs,” which has not happened here).

Postal Service does not know of another shipping company that provides door-to-door delivery of optical discs such as DVDs (DVD-by-mail).”<sup>13</sup> See Rule 3020.32(f).

Additionally, a thorough inquiry would go beyond aggregate elasticity results to look more deeply at the market and its customers, exploring at least two other issues raised in this case: product differentiation and customer segments. First, as the Postal Service acknowledges, “[t]he market for access to digitized entertainment content is a highly differentiated market,” and “the products offered by competing providers differ in a number of product characteristics”<sup>14</sup> Product differentiation is usually associated with meaningfully low elasticities, not high ones.<sup>15</sup> And similar products which nonetheless have key differences may not be perceived as close substitutes (i.e., they may have low cross-elasticities). For example, Netflix’s DVD library has a more extensive range of titles than its streaming library.<sup>16</sup> This has led to the result that a large number of Netflix’s domestic customers, perceiving DVDs-by-mail and streaming as two distinct products, pay extra to subscribe to **both** services. The choices of these “hybrid” subscribers—in the millions—are tangible evidence that streaming is not a close

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<sup>13</sup> See USPS Request, Attachment A at 3. The Postal Service acknowledges in its discussion of Rule 3020.32 (d) that it is the only provider of physical delivery of DVDs; but later in its response to Rule 3020.32(f) on “the availability ... of enterprises in the private sector engaged in the delivery of the product,” it lists as “primary competitors” online streaming/download services provided by Netflix, Blockbuster, Amazon, and Apple, and physical DVD delivery services such as Redbox.” *Id.* at 8. A more responsive answer to Rule 3020.32(f) would have been that there are no “enterprises in the private sector engaged in the delivery” of DVDs.

<sup>14</sup> United States Postal Service Reply to Comments, Docket No. MC2013-57, August 22, 2013, at 10.

<sup>15</sup> As commonly presented in price theory texts, “monopolistic competition” is defined as a situation in which products are differentiated. Those models show relatively low elasticities. For a practical discussion, see Joel Dean, *Managerial Economics*, Prentice-Hall, Englewood Cliffs, N.J., 1951, at 51.

<sup>16</sup> See Comments of Netflix, Inc., Docket No. MC2013-57, August 14, 2013, at 8-9 (explaining the role of the First Sale Doctrine in the compilation of a distinct and comprehensive DVD collection.)

substitute for DVDs-by-mail. The sole fact that the DVDs-by-mail service and the streaming service both participate in the market of “access to digital entertainment content” does not prove that the Round-Trip Mailer has a high elasticity.

Second, a deeper analysis would consider the various customer segments and recognize that some customers are “captive.” The Public Representative has pointed out that many areas in the nation do not have broadband and has cited a study showing that only “70 percent of Americans 18 and older have broadband internet access at home.”<sup>17</sup> Further complicating all this is that broadband speeds vary. Those without suitable broadband access are “captive customers” who depend on the Postal Service for delivery.<sup>18</sup> Other customers may not be technologically savvy or may not choose to invest in the equipment and service needed to stream videos. For all these customers, the Postal Service is the only provider of by-mail delivery. Under these circumstances, it cannot be argued that the Postal Service is constrained by competition in the delivery of DVDs.

A hypothetical may be helpful: If a daughter wants to send Mother’s Day greetings from a distance, several alternatives are available—an email, an e-card, a phone call, Facebook, 1-800-Flowers, Harry and David, and Godiva Chocolates, to name a few. But the fact that there is an array of options for conveying greetings does not mean that the Postal Service has no market power over the rate for delivering the Mother’s Day card. The card manufacturer may consider the array of greeting options in the course of its business planning and marketing strategies, but the Postal Service

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<sup>17</sup> PR Comments at 4.

<sup>18</sup> *Id.* at 5.

would consider competition in the market for Mother's Day greetings only to the extent of its effect on the elasticity of the stamp on the card, i.e., how sensitive mailers are to changes in the price of postage.

In short, the issue is not whether Netflix and GameFly face competition but whether the Postal Service is effectively constrained by competition in setting the price of the Round-Trip Mailer. There is no competition in the delivery of DVDs. Competition in the provision of digital entertainment is only one factor of many to be considered in determining the elasticity of the Round-Trip Mailer product. The Postal Service has failed to submit an adequate analysis of the elasticity of the Round-Trip Mailer, and thus its Request should be denied.

Respectfully submitted,

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