Oral Argument Has Not Been Scheduled

No. 15-1018

IN THE UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

UNITED STATES POSTAL SERVICE,
Petitioner,

v.

POSTAL REGULATORY COMMISSION,
Respondent,

GAMEFLY, INC., and NETFLIX, INC.,
Intervenors for Respondent.

On Petition for Review of Order No. 2306,
Docket Nos. MC2013-57 & CP2013-75,
of the Postal Regulatory Commission

CORRECTED REPLY BRIEF OF THE UNITED STATES POSTAL SERVICE

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FINAL BRIEF:
AUGUST 5, 2015

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

CASES

***Authorities upon which we chiefly rely are marked with asterisks.**

STATUTES

DECISIONS OF THE POSTAL REGULATORY COMMISSION

SECONDARY SOURCES

GLOSSARY

Commission	Postal Regulatory Commission
ICC	Interstate Commerce Commission
JA	Joint Appendix
SA	Supplemental Sealed Appendix

SUMMARY

The Postal Service's opening brief argued that, in defining the relevant market in this matter, the Commission's order asked the right question – whether consumers view movies and video games obtained by other means as reasonably interchangeable substitutes for movies and games rented by DVD-by-mail service – but arrived at the wrong answer – that DVD-by-mail service is a separate product market. The Commission's brief responds principally by changing the question. Even if DVD-by-mail service competes in the same market with other rental services using other delivery channels, the Commission now maintains that the proper question is whether Netflix and GameFly view other delivery channels as reasonable substitutes for the channel they use for distributing their content to customers.

The Commission's order cannot be upheld on this basis. First, it is not the ground on which the Commission's order defined the relevant market for purposes of determining whether the Postal Service's round-trip mailer has sufficient market power. Second, even if the market is defined from the point of view of content distributors rather than consumers, the central issue remains whether consumers view the various delivery channels to be reasonable substitutes. DVD-by-mail providers' demand for mail delivery is derived entirely from consumer demand for their services – no one purchases a round-trip mailer unless a customer seeks

access to a movie or game from a DVD-by-mail provider – so, if DVD-by-mail service is part of a broader market, then so is the distribution channel used by that service. Finally, even if the "delivery channel" market were somehow independent of the "movie rental" market, the Commission's brief does not analyze the former market: it focuses exclusively on the two companies that provide DVD-by-mail service and then assumes that the market must be the distribution channel that they (and only they) have in common. In doing so, it disregards the significant competition that distributors of movies and video games (including Netflix and GameFly) have admitted they face, *see* Pet. Br. at 51-52, which in turn constrains the Postal Service.

The result of the Commission's approach is a completely artificial "market" that consists of a single service (delivery of rented DVDs by mail), sold by a single entity (the Postal Service), and purchased essentially by a single company (Netflix).[1] Under the Commission's flawed logic, as long as anyone anywhere demands a movie from Netflix's DVD-by-mail service, the Postal Service has "market power" because it delivers that movie. Because the Postal Service has "market power" under the Commission's logic until DVD-by-mail service is

[1] GameFly also uses DVD-by-mail service, but Netflix accounts for 98 percent of DVD-by-mail volume (and thus uses 98 percent of the round-trip mailers). The Postal Service's opening brief explained why the market-definition inquiry should focus on Netflix and its DVD-by-mail customers. Pet. Br. at 37-39. The Commission did not object to that argument, so this reply will focus primarily on Netflix's DVD-by-mail service.

displaced from the market entirely, DVD-by-mail service is the only movie-rental business model whose delivery costs are insulated from market forces. By singling out one customer and one delivery channel, the Commission's approach leads to a skewed result that would give preference to certain market players but not others, thus subverting the primary purpose of antitrust law: to protect competition, not individual competitors. It also ignores the reality that consumers can choose among several different services (using different delivery channels) to access movies to watch at home, and DVD-by-mail service is one option utilized in a relatively small (and rapidly dwindling) percentage of such transactions.

Intermittent portions of the Commission's brief do attempt to defend its actual holding below: that consumers do not in fact view streaming or kiosks to be reasonably interchangeable substitutes for DVD-by-mail service. But the Commission largely ignores the Postal Service's arguments and merely restates the tautologies on which its original order rested. And it continues to give short shrift to the question of whether the Postal Service has market power even if DVD-by-mail service is somehow a unique market. For these reasons, the Commission's order should be remanded.

ARGUMENT

I. THE COMMISSION'S INTERPRETATION OF ANTITRUST LAW IS NOT ENTITLED TO DEFERENCE.

In giving content to the "sufficient market power" standard under 39 U.S.C. § 3642(b)(1), the Commission's order established a framework that starts by defining the relevant market under antitrust law. JA574. The statutory language is sufficiently ambiguous to permit that framework. *Cf. Newspaper Ass'n of Am. v. Postal Regulatory Comm'n*, 734 F.3d 1208, 1214 (D.C. Cir. 2013) (term "unreasonable harm to the marketplace" is ambiguous and, to give it "content," Commission "is at liberty to look to other bodies of law"). Far from arguing that the Commission is owed "no deference" in interpreting the statute, Resp. Br. at 19, the Postal Service concedes that the Commission's chosen framework reflected a reasonable interpretation of the statutory language and is entitled to deference. Pet. Br. at 25.

Upon announcing that its definition of the relevant market is governed by antitrust law, however, the Commission is not entitled to deference where it misapplies the settled antitrust principles on which it purports to rely. Nothing in *Newspaper Association* suggests that the Commission's interpretation or application of antitrust law is itself entitled to deference. Rather, this Court deferred to the Commission's decision concerning the extent to which it would rely on antitrust law in interpreting a statutory term. *See Newspaper Ass'n*, 734 F.3d at

1215; *Northern Natural Gas Co. v. Fed. Power Comm'n*, 399 F.2d 953, 961 (D.C. Cir. 1968) (regulator is not "strictly bound" by the dictates of antitrust law in construing separate statute). Here, the Commission chose to rely entirely on "case law and generally accepted antitrust principles" in defining the relevant market, JA603, and nowhere suggested that (or how) its analysis was departing from such principles. Nor is the Commission's definition of the market here, unlike the analysis of "harm to the marketplace" in *Newspaper Association*, based on "predictive judgments about the likely economic effects of a rule," Resp. Br. at 19-20 (quoting *Newspaper Ass'n*). Instead, the Commission was analyzing whether consumers view different products as reasonably interchangeable substitutes. Having chosen to engage in an antitrust inquiry under a body of law developed by case law interpreting statutes that the Commission does not implement and over which it has no expertise, its interpretation of the relevant legal principles is owed no deference.[2]

Despite relying exclusively on antitrust law below, the Commission's brief obliquely suggests now that it should be entitled to apply a more stringent set of (unannounced) principles, explaining that heightened regulatory oversight is

[2] Accordingly, this case is different from *CF Industries, Inc. v. Surface Transportation Board*, 255 F.3d 816 (D.C. Cir. 2001), another case on which the Commission's brief relies (at 20). The Board was entitled to deference there because its methodology to measure "market dominance" was based on a body of precedents and regulations developed by the Board and its predecessor agency. 255 F.3d at 822-24.

needed because the "Postal Service is immune from suit under the federal antitrust laws." Resp. Br. at 3. Even if the Commission could claim deference based on this post hoc suggestion, the predicate is false. The Postal Service has no such antitrust immunity. The case on which the Commission relies, *U.S. Postal Service v. Flamingo Industries (USA) Ltd.*, 540 U.S. 736 (2004), was superseded on that point by the same statute that introduced the "sufficient market power" provision at issue in this case. *See* 39 U.S.C. § 409(e)(1) (other than for conduct concerning products reserved to the United States under 18 U.S.C. § 1696, Postal Service "shall not be immune from suit" for any violation of federal law, including "the antitrust laws").[3]

II. THE COMMISSION'S ATTEMPT TO RE-DEFINE THE RELEVANT MARKET ON APPEAL DOES NOT PROVIDE A VALID GROUND FOR AFFIRMANCE.

A. The Commission May Not Defend Its Order on Grounds Other Than Those on Which it Relied Below.

The Commission cannot seek affirmance by advancing on appeal a new approach for defining the relevant market. Although the Commission's order noted that the companies offering DVD-by-mail service are the Postal Service's "direct consumers," JA595, the Commission's market-definition analysis was

[3] The Commission's order did not decide whether the round-trip mailer falls within 18 U.S.C. § 1696. JA613-15. If it does, then it cannot be deemed a competitive product anyway. *See* 39 U.S.C. § 3642(b)(2) (a product covered by 18 U.S.C. § 1696 cannot be transferred "from the market-dominant category of mail").

devoted to answering whether there is adequate competition for the DVD-by-mail service that Netflix and GameFly offer, *i.e.*, whether under principles of antitrust law DVD-by-mail service is part of a broader product market that includes other services – utilizing streaming, downloads, and physical locations (including kiosks) – from which consumers may rent movies or video games. Despite the undisputed facts that (1) DVD-by-mail service is not, and has never been, the only way for consumers to rent DVDs, let alone to watch movies or play video games at home, SA626-27, and (2) consumer demand for DVD-by-mail service has declined dramatically in recent years as consumers have switched to other methods of renting videos and video games, JA142-43, SA627-36, the Commission concluded that end consumers view those other methods of renting movies or video games as inadequate substitutes for DVD-by-mail service and therefore are not in the same product market. JA562 (finding inadequate competition in the broader "digitized entertainment content market").

The Commission's order relied on three factors, summarized in the section entitled "Findings and Conclusions Regarding the Relevant Market," JA603-04, to support its conclusion that "DVDs-by-mail is [not] part of a broader product market that uses . . . other technologies to deliver movie and game content." JA603. First, the Commission relied on the purported limits on the content available by other means. JA603-04. Second, the Commission stated that a "core

group of customers" now using DVD-by-mail service "either prefer or require DVDs-by-mail service to consume certain video content," JA604, JA572. Finally, the Commission concluded that "industry participants currently perceive DVDs-by-mail to constitute a separate and distinct product market" because not all digital content is presently "available by delivery systems other than DVDs-by-mail." JA602-04. Each of those factors clearly concerned whether the ultimate consumers of movies and video games – or at least a supposedly "core" group of such consumers – view other methods of renting movies or video games to be reasonable substitutes for DVD-by-mail service.

Now, with the Postal Service challenging the Commission's conclusion that end users view DVD-by-mail service as a market unto itself, the Commission's brief contends that the question that its "findings and conclusions" were plainly designed to answer was the "wrong antitrust question" all along. Resp. Br. at 31. The Commission now asserts that, *even if* DVD-by-mail service competes in a broader market – *i.e.*, even if consumers perceive DVD-by-mail service as reasonably interchangeable with other means of renting movies or video games – the correct question is whether the firms that have chosen to compete in that broader market by adopting a DVD-by-mail business model would perceive other methods of distributing their content to be reasonably interchangeable with mail delivery. *Id.* at 31-34.

That was not the basis on which its order found that the Postal Service had "sufficient market power" under 39 U.S.C. § 3642(b)(1), and "an administrative order cannot be upheld unless the grounds upon which the agency acted in exercising its powers were those upon which its action can be sustained." *SEC v. Chenery Corp.*, 318 U.S. 80, 95 (1943); *LePage's 2000, Inc. v. Postal Regulatory Comm'n*, 642 F.3d 225, 232 (D.C. Cir. 2011) (Court "cannot accept appellate counsel's post hoc rationalizations for agency action; for an agency's order must be upheld, if at all, on the same basis articulated in the order by the agency itself.") (citations omitted); *U.S. Postal Serv. v. Postal Regulatory Comm'n*, 785 F.3d 740, 755 (D.C. Cir. 2015) (same).

The Commission's order conceded that it never considered whether the Postal Service has market power if consumers view other means of obtaining movies as reasonably interchangeable alternatives to movies rented through DVD-by-mail service. JA607 at n.33. Accordingly, it cannot now advance an alternative argument that the Postal Service has market power regardless of whether DVD-by-mail service is part of a broader market.

B. Whether Measured From the Point of View of Content Providers or Consumers, the Critical Question is Whether Other Methods of Providing Movies and Video Games are Reasonably Interchangeable Substitutes for DVD-By-Mail Service.

In any event, the Commission gains nothing from its effort to reexamine the relevant market in terms of the delivery channels that content providers use rather

than the services they provide. If consumers perceive a movie rented on a DVD from Netflix as reasonably interchangeable with (and thus in the same product market as) a movie rented from Redbox, Amazon Prime, Comcast, or Netflix's streaming service (among others), then they necessarily view the various delivery channels as reasonably interchangeable as well.[4] And if the mail is simply one of the many delivery channels by which consumers can receive a movie, it is one of the many delivery channels that content providers – the potential "direct" customers on which the Commission now wants to focus – can choose to make movies available to their customers. The Commission concedes that movie distributors' demand for the round-trip mailer is derived from consumer demand for DVD-by-mail service, JA595: if a customer does not order a movie from Netflix's DVD-by-mail service, then Netflix does not use or pay for mail delivery from the Postal Service. That is why the Commission's order properly defined the market from the perspective of the end consumer.

[4] The Commission's brief twice suggests in passing that consumer demand for DVD-by-mail service may be driven by the unique properties of the delivery channel – specifically, "convenient door-to-door delivery" offered by the mail. Resp. Br. at 30, 44. But the pages of the order that the brief cites (JA589, 592, 596-97) say nothing about the relative "convenience" of mail delivery. It is not clear why consumers would view mail delivery as inherently more "convenient" than alternative delivery channels: kiosks, like mail, make DVDs available at locations where consumers will routinely be, while streaming instantly delivers movies on demand directly to their screens.

Because the supposed "market" for the delivery of movies is derivative of the market for movie rentals themselves, it follows that the Postal Service lacks power in the former "market" if Netflix's DVD-by-mail service lacks power in the latter market. And Netflix's DVD-by-mail service lacks power in the broader "movie rental" market. The Commission's brief apparently concedes the point, *see* Resp. Br. at 34, and certainly cannot deny that far more consumers rent movies from other physical delivery channels than from the mail, *see* SA626 (in June 2013, kiosks accounted for 49 percent of physical DVD rentals, other retail locations accounted for 24 percent, and DVD-by-mail service accounted for 27 percent), and rentals from all physical delivery channels are dwarfed by rentals from digital-based distribution channels. *See* SA746 (showing that, of Netflix's customers alone, far more than 10 times as many customers subscribe solely to streaming service as subscribe solely to DVD-by-mail service).[5] Because Netflix's DVD-by-mail service has a small and shrinking share of the consumer movie-rental market, it necessarily follows that mail delivery has an equally small and shrinking share of the derivative "delivery channel" market. So, asking a different "antitrust question" by shifting the inquiry from movie consumers to movie distributors should produce the same answer.

[5] The overall ratio of streaming customers to DVD-by-mail customers is much higher than that. Netflix accounts for 98 percent of all DVD-by-mail volume but a far lower percentage of all streaming volume because several major firms also provide streaming services.

The suggestion to the contrary in the Commission's brief is based almost entirely on its misinterpretation of this Court's opinion in *Coal Exporters Ass'n v. United States*, 745 F.2d 76 (D.C. Cir. 1984), *see* Resp. Br. at 32-34 – a case, incidentally, that the Commission's order substantively discussed only in a footnote and only *after* it had defined the market. JA611 at n.28. The *Coal Exporters* decision concerned a different statute and involved an entirely different industry, and does not support the necessary premise of the Commission's argument: that the market for distribution of a product is narrower than the market for the product itself.

In fact, *Coal Exporters* is not a case about market definition at all. Under the statute at issue in that case, the Staggers Rail Act of 1980, the Interstate Commerce Commission (ICC) could exempt rail carriers from rate regulation only if it found that the railroads lacked "market power" or there existed "effective competition" (from railroads or other delivery channels) that would prevent the abuse of such power. *Coal Exporters*, 745 F.2d at 90. The ICC allowed an exemption for all rail transportation of coal destined for export despite not making either finding, *id.*, and despite the fact that its analysis "rested on the premise that unregulated railroads would be able and willing to price discriminate actively among coal shippers," a premise that "clearly assumes some significant degree of railroad monopoly power." *Id.* at 90-91; *accord id.* at 99 (ICC's opinion "predicts

a pricing regime . . . premised on the railroads' use of market power"). The Court concluded that the statute did not permit the ICC to allow an exemption where market power was found to exist, and further that the ICC could not interpret the phrase "abuse of market power" as limited to situations where railroads' prices were completely unconstrained – *i.e.*, where railroads could charge rates that "prevent shippers' full cost recovery" or could "totally exclude them from the division of economic rents." *Id.* at 98. Thus, although the ICC pointed to certain competitive forces – *e.g.*, broad competition in the world product market for coal, competition from other modes of transportation – that place *some* constraints on the price railroads could charge export-coal shippers, its analysis revealed that it did not find such constraints sufficient to strip railroads of significant monopoly power over shippers. *Id.* at 90.

Coal Exporters did not hold that a carrier may have market power in a derivative transportation market where the primary market is competitive. It did not determine the degree to which the "downstream" market was competitive, an issue on which the evidence was inconclusive at best, *id.* at 83-84 & n.10, because the ICC's "decision to exempt export coal [was] only indirectly related" to the presence of some competition in the downstream worldwide market for coal. *Id.* at 90. It held simply that, where the ICC finds that railroad carriers have market power in the transportation market – there, by virtue of their ability to "price

discriminate actively among coal shippers," *id.* at 90 – it cannot exempt such carriers from rate regulation under the statute. Accordingly, it is irrelevant to the principal question that the Commission now asks: whether the delivery method used by DVD-by-mail providers is part of a broader market that includes several different delivery channels that businesses can use to provide consumers with access to movies and video games.

Had the Commission's order defined the market from the perspective of "consumers" of delivery channels rather than consumers of the product being delivered – which it did not – the critical issue still would have been whether the underlying "products" are reasonably interchangeable. If a movie that is stored on a DVD and made available by mail, a movie that is stored on a DVD and made available at a local kiosk, and a movie that is transmitted digitally over a fiber-optic line are all reasonably interchangeable, then the delivery methods that those services use are themselves interchangeable (or, in the parlance of 39 U.S.C. § 3642(b)(1), are "similar products").

C. Even if the Market for the Delivery Channels that Content Providers Use and the Services they Provide Can Be Analyzed Independently, the Commission's Exclusive Focus on Netflix and GameFly Prevents it From Properly Analyzing the "Delivery Channel" Market.

Finally, even if the derivative market for the delivery of rented movies can be analyzed independently of the market for movie rentals, the Commission's brief

does not actually analyze the competitive conditions in that derivative market. Rather than assess whether the delivery channels compete with each other to attract content providers, the Commission focuses only on the two companies that offer DVD-by-mail service and baldly declares that the entire market is limited to the delivery channel that those two companies use to distribute their content. Because the Postal Service provides "the exclusive method of delivery Netflix and GameFly use to operate their DVD-by-mail rental services," Resp. Br. at 10 – a point the Commission's brief echoes repeatedly, *see id.* at 1, 5, 14, 17, 18, 23, 40, 46 – the Postal Service must have power in that "market." *See id*. at 32 (Commission "focused its market-power analysis on the consumers of the round-trip DVD mailer—Netflix and GameFly.").

The limited focus on a single delivery channel used by only two companies sidesteps rather than analyzes the scope of the delivery-channel market and mail delivery's place in it. There are many services that transmit movies but, by the Commission's logic, as long at least one customer chooses a particular differentiated service in a given market, that service is a market unto itself. The Commission denies that it seeks to define the market in terms of a single product, Resp. Br. at 39, but that is precisely what it has done: it has concluded that "the Postal Service's round-trip DVD mailer is the relevant market," *id.* at 13, because that is the method of delivery that its two existing customers use. *Id*. at 17. And

that is not how a market is defined. *See Neumann v. Reinforced Earth Co.*, 786 F.2d 424, 429 (D.C. Cir. 1986) ("It makes no sense [to demonstrate] monopoly power by defining the market as those customers whom the entrant has … managed to persuade."); *Queen City Pizza, Inc. v. Domino's Pizza, Inc.*, 124 F.3d 430, 438 (3d Cir. 1997) ("The test for a relevant market is not commodities reasonably interchangeable by a particular plaintiff, but commodities reasonably interchangeable by consumers for the same purposes.") (citation omitted).

The context in which DVD-by-mail service arose confirms that mail delivery of DVDs cannot be its own market. The Postal Service did not impose mail delivery on Netflix. Instead, Netflix decided to build a movie-rental business around Internet subscriptions and mail delivery (thus spawning the introduction of the round-trip mailer) to both distinguish itself from and compete with incumbent retail locations like Blockbuster. In that sense, Netflix is no different from the franchisees in *Queen City*, who were free to become franchisees of any restaurant chain to compete in the marketplace but chose to become franchisees of Domino's Pizza. Having made that decision, they had no antitrust claim when they had to adhere to the terms of their franchise agreement, including the obligation to purchase ingredients and supplies from Domino's. 124 F.3d at 438.

Indeed, unlike the franchisees in *Queen City*, Netflix and GameFly are not locked into the use of mail delivery: they have no contractual restraints preventing

them from choosing a different delivery channel if they are dissatisfied with the prices the Postal Service offers or they otherwise determine that a business model centered around a different delivery channel will make them more competitive in the marketplace. Indeed, Netflix, the company that still accounts for 98 percent of all DVD-by-mail volume, itself now primarily uses other delivery channels to distribute movies. And a large and growing number of competitors offer delivery by other means – including RedBox, Amazon, iTunes, Google Play, Hulu, HBO Now, and satellite TV. Those facts alone keep pressure on the Postal Service to set delivery prices at a competitive level: the Postal Service has a clear incentive to keep mail as an attractive medium for conveying movies. At the same time, the Commission has not claimed that the Postal Service has the power to erect barriers preventing other carriers from delivering DVDs or to prevent firms that once used mail delivery from shifting to other delivery channels.

The Commission states that Netflix and GameFly would not abandon the mail because other distribution channels are too expensive. *See* Resp. Br. at 24-25 (Internet streaming is not a reasonable substitute because "licensing is far more expensive"); *id.* at 42 (kiosks are not viable because of their "high capital costs"); *accord* Intervenor Br. at 28-29 (streaming is more expensive). Even if this were true – although Netflix's actual conduct indicates otherwise – this is precisely why the Commission's exclusive focus on Netflix and GameFly, and its failure to

consider the broader competitive forces in the industry, is flawed. Other rental companies have successfully used those delivery channels; Redbox, for example, delivers its DVDs by kiosk and rents far more DVDs than Netflix and GameFly combined. If firms using the DVD-by-mail model compete in the same market as those other businesses, the role of antitrust law is not to protect the first group against competition from the second group by freezing its delivery costs in place while its competitors' costs are subject to the forces of the marketplace. Antitrust law exists to protect competition, not individual competitors. *E.g.*, *Covad Comm'ns Co. v. Bell Atl. Corp.*, 398 F.3d 666, 674 (D.C. Cir. 2005).

III. THE COMMISSION'S EFFORT TO JUSTIFY ITS ORDER'S CONCLUSION THAT DVD-BY-MAIL SERVICE IS A UNIQUE MARKET REPEATS THE FLAWS THAT THE POSTAL SERVICE'S OPENING BRIEF IDENTIFIED.

The discussion above assumes that consumers view movies rented through other means to be reasonably interchangeable with movies rented through DVD-by-mail service. The Commission's order concluded otherwise, of course, and sporadic portions of the Commission's brief defend that conclusion. *See* Resp. Br. at 28-31, 36-41, 43-46. But the Commission's brief devotes scant attention to the three factors summarized at JA603-04 that drove the Commission's decision or to the Postal Service's arguments on appeal. Instead, the Commission mainly

reiterates facts that no one disputes or assures the Court, often without elaboration, that its analysis was reasonable.[6]

The Commission's principal argument is that "[m]ost of the titles in the vast collection of DVDs available from Netflix and GameFly are not available to rent via streaming services or from physical kiosks," Resp. Br. at 30-31, which supposedly entitled the Commission to infer that the greater selection was the reason that customers remain "loyal" to DVD-by-mail service and do not regard other means of obtaining movies and video games to be adequate substitutes. *Id.* at 44; *see also id.* at 16 (Commission "reasonably concluded that consumers likely place a distinctive value on the vastly superior selection" offered by DVD-by-mail

[6] *E.g.*, Resp. Br. at 15 ("Commission reasonably relied on evidence that Netflix, GameFly, and the millions of customers who still subscribe to DVD-by-mail services" view all alternatives as "distinct"); *id.* at 16 ("Commission reasonably relied on evidence that the DVD-by-mail customer base is loyal"); *id.* at 25 ("Commission reasonably concluded that the huge difference in available content" gives different services "vastly different characteristics"); *id.* at 30 ("Commission reasonably noted the variety of respects that consumers view DVD-by-mail service as distinctive"); *id.* at 30-31 ("Commission reasonably relied" on differences in available titles "in concluding that the round-trip DVD mailer is the relevant market"); *id.* at 38 ("Commission reasonably concluded that the differences between digitized entertainment provided on discs delivered by means of round-trip DVD mailers and digitized entertainment delivered by other means are substantial enough that they are not differentiated products, but rather are in different markets"); *id.* at 41 ("Commission reasonably concluded that consumers view a DVD-by-mail subscription to Netflix or GameFly as quite different from the possibility of renting from the vastly inferior content selection available at Redbox kiosks"); *id.* at 44 ("Commission reasonably noted … ample reasons to think that Netflix's and GameFly's customer base is indeed loyal").

services). But the factual predicate is dubious, and the Commission continues to cite no evidence supporting the inference it drew.

As for the premise, that DVD-by-mail service offers "vastly superior selection," the Commission's brief ignores the order's observation that there is significant overlap in the titles available among the various sources. *See* JA602 (conceding that, generally speaking, "digital movies and games can be viewed as available from a broad spectrum of sources"). Particularly with movies, the differences in companies' inventories are a function not of any inherent limitations of a given platform or distribution channel – even the intervenors' brief points to no technological restrictions on the provision of movies on other platforms, *see* Intervenor Br. at 30-31 – but of a given company's business decision based on the cost of obtaining the rights and the predicted demand of any given movie. There is nothing preventing a streaming or kiosk-based service from increasing its number of titles or changing the mix of titles to meet demand – they do that all the time.

As for the inference, that consumers use DVD-by-mail service because such services offer titles unavailable anywhere else, the Commission has pointed to no evidence supporting it. Netflix submitted no evidence, for example, that its customers subscribe mainly to obtain obscure titles unavailable from kiosks or streaming rather than the more popular titles that are available from other services. While the Postal Service has no way to know exactly which titles Netflix's

customers order, there is ample reason to suspect that Netflix's customers do not use DVD-by-mail service primarily to watch movies unavailable elsewhere: if they did, the number of such subscribers would not be in freefall.

The Commission does not dispute that customers are leaving DVD-by-mail service for alternatives – *i.e.*, that "broad secular market trends" have reduced the relative popularity of DVD-by-mail service. Resp. Br. at 17. Rather, the Commission contends that the phenomenon reveals nothing about the proper scope of the market because the Postal Service failed to show that customers are switching because of changes in the relative *price* of DVD-by-mail service and the more popular alternatives. *Id*. at 35-37. Putting aside that the Commission's brief elsewhere suggests that DVD-by-mail customers are, in fact, sensitive to price, *see id*. at 34 (conceding that price increases for "DVD-by-mail services provided by Netflix and GameFly might well induce some consumers to switch" to other movie and game distributors and that, accordingly, "there was evidence" that Netflix and GameFly would not raise prices), the Commission's assertion both misstates the applicable legal standard and distorts the nature of the competition between the various content providers.

The Postal Service need not show that customers are leaving DVD-by-mail service for alternatives because of changes in their relative prices. *See* IIB Phillip E. Areeda & Herbert Hovenkamp, *Antitrust Law* ¶ 562, at 371 (3d. ed. 2007)

("actual shifts between two products in response to – or even without – changes in their relative prices indicate a single market"). The fact that customers have switched away from DVD-by-mail even *absent* a change in price is alone evidence that a price increase would only exacerbate the decline. In any event, price is only one dimension of competition within the market. *U.S. v. Cont'l Can Co.*, 378 U.S. 441, 455 (1964).

The Commission's observation that consumers perceive distinctions between the various services, Resp. Br. at 30, 43, 44, is undoubtedly accurate but does not alone suggest that the services are in different markets. The question is whether, despite those differences, customers view the services as "reasonably interchangeable" for performing "the same purposes." *U.S. v. E.I. du Pont de Nemours & Co.*, 351 U.S. 377, 395 (1956). Here, the customers' purpose is to watch a movie at home. DVD-by-mail service, streaming, and kiosks each perform that function equally well: the user experience is the same whether the movie is streamed through a cable box and viewed on a television screen or played by a DVD player from a DVD rented from either a physical location or a DVD-by-mail service. Because of this functional similarity, companies like RedBox, Amazon, Comcast, and Netflix compete with each other by differentiating their products from their competitors', *i.e.*, by offering a package of content, convenience and price that will persuade customers to use their services. If price

were the only dimension in which companies compete, they would not bother distinguishing their products to convince consumers that their services are better (rather than merely cheaper).

Indeed, the battle for market share among the various movie-rental companies has always involved product differentiation rather than merely price competition. In both its brief and its order, the Commission recognized the multi-faceted nature of such competition in discussing how Netflix's DVD-by-mail service helped cause the demise of Blockbuster and similar brick-and-mortar rental businesses. Resp. Br. at 42 (conceding that "Netflix's DVD-by-mail business drove Blockbuster, whose principal business was renting DVDs via physical retail locations, into bankruptcy"); JA594. Certainly DVD-by-mail service could not have been a distinct product market *then*, even though the Commission does not suggest that Netflix out-competed Blockbuster by undercutting its prices. It instead supplanted Blockbuster by developing a combination of features (including inventory and delivery method) that customers found to be more valuable than the features Blockbuster offered. Having recognized that DVD-by-mail service was in a broader market then, the Commission has not articulated a sound reason to treat it as a market of its own now, as other business models using other distribution channels – including kiosks, which are essentially next-generation brick-and-

mortar DVD rental stores – have stripped DVD-by-mail service of much of the market share it gained by driving Blockbuster out of business.

Even if *some* customers subscribe to DVD-by-mail service to obtain titles that are unavailable elsewhere, that suggests only that Netflix's effort at product differentiation has been effective. The point of product differentiation, after all, is to create such preferences. *See* IIB Areeda & Hovenkamp, ¶ 563a at 383. But the Commission goes further, suggesting that all remaining DVD-by-mail customers are unusually loyal and thus will not be swayed by newer alternatives. Resp. Br. at 43-44. This would be relevant if true, but the only supporting evidence the Commission cites is that (as of September 2013) two-thirds of Netflix's DVD-by-mail customers also subscribe to Netflix's streaming service. *Id.* at 44. That is a misleading statistic[7]; the overwhelming majority of Netflix's customers subscribe to only one of the two services, with the vast (and growing) majority subscribing only to its streaming service and the rest subscribing either solely to its DVD-by-mail service or to both services. SA746. The fact that most of the shrinking number of DVD-by-mail customers also use a streaming service to rent movies suggests that the hypothetical "core" DVD-by-mail customer of today could easily

[7] As an illustration, if there were two rental companies, and 88 customers rent movies entirely from Company A, four rent entirely from Company B, and eight rent from both companies, it is true that two-thirds of Company B's customers also rent from Company A. But the important statistics are (1) nearly all customers rent from only one of the two companies, and (2) nearly all of them rent from Company A.

be a former DVD-by-mail customer tomorrow, as alternative delivery methods continue to play an increasingly significant role in the market. The Commission's backward-looking snapshot fails to account for this reality.

In any event, there is nothing particularly noteworthy about the fact that some customers find sufficient value in two competing products that they use both. Some consumers have a digital subscription to the Financial Times and a home-delivery subscription to the Wall Street Journal, or load two antivirus programs on their computers, or watch television shows on two different networks. No one would argue that the respective companies do not directly compete with each other.

The Commission also notes that some customers lack broadband access and thus are unable to use streaming services. Resp. Br. at 41. But the fact that two-thirds of Netflix's remaining DVD-by-mail subscribers also subscribe to its streaming service strongly suggests that the number of consumers who *require* physical delivery channels is fairly small, particularly because DVD-by-mail subscribers need Internet access and an on-line account. But even among the consumers who require physical delivery to rent a movie, the record shows that only 27 percent of rented DVDs are delivered by DVD-by-mail services. Kiosks – which, like DVD-by-mail service, offer round-trip delivery of physical DVDs at locations convenient for consumers – alone account for twice as many DVD rentals as mail delivery. SA626, JA142, JA591. Including Redbox *and no one*

else in the same market as the two DVD-by-mail companies is sufficient to preclude a finding that DVD-by-mail has power in the market.

At most, the Commission's musings raise the possibility that some consumers, for whatever reason, see DVD-by-mail service as a uniquely attractive method by which to rent movies. That possibility does not itself come close to establishing that DVD-by-mail service is a separate market, however. The Commission had to continue the analysis by developing a record showing how many DVD-by-mail consumers view the alternatives as inadequate and assessing whether the number of such consumers is sufficient to put them in a different market. *Cf. FTC v. Whole Foods Market, Inc.*, 548 F.3d 1028, 1040-41 (D.C. Cir. 2008) (opinion of Brown, J.). The Postal Service carried its burden of demonstrating that there are numerous movie-rental alternatives using various delivery channels and that a small and shrinking percentage of consumers choose DVD-by-mail service among those alternatives. The Postal Service has no way to identify why Netflix's remaining DVD-by-mail customers subscribe to its service or how many such customers view alternative services as inadequate. If the Commission suspects that the remaining DVD-by-mail customers exist because they have no reasonable alternatives, reasoned decisionmaking requires the Commission to test the validity of its hypothesis. Its failure to build an evidentiary

basis for its conclusion – or even to recognize that such a basis is needed – justifies a remand.

IV. EVEN IF THE COMMISSION CORRECTLY CONCLUDED THAT DVD-BY-MAIL SERVICE IS A UNIQUE MARKET, ITS MARKET-POWER ANALYSIS REMAINS INCOMPLETE.

Market definition is not an end in and of itself but rather a first step in evaluating market power. Even if DVD-by-mail service were a unique market because its consumers would not rent movies from any other source, the Commission's market-power analysis remains incomplete because it fails to account for the significant competitive constraints the Postal Service faces. It is true that the Postal Service would be the sole supplier of delivery services in such a "market." But it is equally true that Netflix would be essentially both the sole provider of DVD-by-mail service *and* the sole direct purchaser of delivery services. Thus, the unanswered question is whether Netflix's position gives it monopsony power over the Postal Service – *i.e.*, market power on the "buy" side of the market – such that it could prevent the Postal Service from raising delivery prices above a competitive level. *See, e.g., West Penn Allegheny Health Sys., Inc. v. UPMC*, 627 F.3d 85, 103 (3d Cir. 2010) ("A firm that has substantial power on

the buy side of the market . . . is generally free to bargain aggressively when negotiating the prices it will pay for goods and services.").[8]

The Commission continues its refusal to even consider the relative bargaining positions of the Postal Service and Netflix, arguing that that there is "no evidence" of any such buying power because Netflix has "no choice" but to accept the Postal Service's product at the Postal Service's prices. Resp. Br. at 49. It has again wholly ignored the proceedings that gave rise to the instant appeal, which were premised on the Postal Service affording Netflix special treatment because of its purchasing power over the Postal Service. *See* Pet. Br. at 57-58. And it has ignored Netflix's actual statement in those proceedings that any increase in postal delivery prices would "accelerate the ultimate decline of DVD shipments as Netflix would shift more resource to the digital delivery of content." Comments of Netflix, Docket No. C2009-1, at 2 (P.R.C. filed Aug. 30, 2010), *available at* http://tinyurl.com/n65brjj. The Commission held that the Postal Service had given Netflix preferential pricing and terms of service even though they increased the Postal Service's costs. Order No. 718, Docket No. C2009-1, at 90, 96 (P.R.C. Apr.

[8] The intervenors suggest that Netflix's buying power would not protect GameFly, Intervenor Br. at 44-45, but GameFly is protected by the order, which this Court affirmed, that the Postal Service must charge the same price to all DVD-by-mail companies. *U.S. Postal Serv. v. Postal Regulatory Comm'n*, 747 F.3d 906, 908-09 (D.C. Cir. 2014).

20, 2011), *available at* http://tinyurl.com/n4sdfo3. Such actions make no sense if, in fact, the Postal Service had market power over Netflix.

The Commission's brief also entirely misses the point about technological change. It does not dispute that the underlying market is dynamic and in transition. But it ignores the main driver of that transition – namely, the emergence of streaming as the dominant method by which consumers watch movies. It is not a "speculative future technological advance[]," Resp. Br. at 50, that may "someday" be a "viable substitute for DVD-by-mail service." *Id.* at 49. It is here now. SA635-36 (industry analysis from 2013 concludes that demand for DVD-by-mail service has been "cannibalized" by kiosks and "direct substitutes" like streaming and video-on-demand). The Commission also ignores the significance of that transition – that consumers are presented with an array of streaming services, with ever-expanding content offerings, that threaten to take away even the supposed "core" DVD-by-mail customers (if such customers even exist). In such a rapidly evolving environment, which by 2013 had already claimed more than *half* of the DVD-by-mail customers that existed in 2010, SA758, that threat alone is sufficient to constrain prices that the Postal Service may charge.

CONCLUSION

This Court should grant the petition for review and remand the matter to the Commission for further proceedings.

Dated: August 5, 2015

Respectfully submitted,

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CERTIFICATE OF COMPLIANCE

I hereby certify, pursuant to Fed. R. App. P. 32(a)(7), that the foregoing Corrected Reply Brief of the United States Postal Service uses proportionately spaced, 14-point type, and contains 6,945 words as measured by Microsoft Word, a word processing system that includes footnotes and citations in word counts.

/s/ David C. Belt
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Dated: August 5, 2015

CERTIFICATE OF SERVICE

I hereby certify that on August 5, 2015, the foregoing corrected brief was electronically filed with the U.S. Court of Appeals for the District of Columbia Circuit by using the CM/ECF system. I further certify that counsel for the respondent and the intervenors are registered as ECF filers and that they will be served by the CM/ECF system.

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