

Written Testimony of Andrew Rendich
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Before a Joint Hearing Of

The Senate Homeland Security and Governmental Affairs Committee's Subcommittee
on Federal Financial Management, Government Information, Federal Services, and
International Security

And

The House Committee on Oversight and Government Reform Subcommittee on
Federal Workforce, Postal Service, and the District of Columbia

On

Having Their Say:
Customer and Employee Views on the Future of the U.S. Postal Service

Wednesday, June 23, 2010

INTRODUCTION

Chairmen Lieberman, Carper, Towns, and Lynch, Ranking Members Collins, McCain, Issa and Caffretz, and members of the subcommittees, I am Andrew Rendich, Chief Service and DVD Operations Officer of Netflix, Inc. I am very pleased to appear before you today to discuss issues related to the future of the Postal Service.

EXECUTIVE SUMMARY

With more than 14 million subscribers, Netflix is the world's largest online subscription service streaming movies and TV episodes over the Internet and sending DVDs by U.S. mail. On average, approximately two million discs are shipped by U.S. mail from our nationwide network of distribution centers every day. For 2010, we anticipate spending approximately \$600 million dollars on postage, making us the largest growing first-class mailer in the country. While Netflix delivers movies and TV episodes two ways – by streaming directly over the Internet and through DVDs by mail – my comments today will be focused on the DVD side of our business.

Our subscribers depend upon the Postal Service to deliver their DVDs quickly and in good condition. Since starting our business in 1998, the Postal Service has been an extremely reliable partner, helping Netflix achieve award-winning customer satisfaction and scaling with our own growth. In light of this relationship, we are keenly interested in working with the Postal Service and Congress to ensure that our nation's mail service continues to be reliable, trusted and affordable.

Among our key comments, which are outlined below in more detail, we offer the following highlights:

- Netflix believes that a well-functioning Postal Service, positioned over the long haul to meet changing customer and consumer demand, is more important than maintaining current delivery frequency at the expense of the broader health and continued operational reliability of the nation's mail service. We believe that those subscribers who currently rely upon Saturday postal delivery to receive and watch movies on the weekend would adjust their rental habits to account for the Postal Service's change in delivery and would plan their DVD rental selections around the fact that mail would not arrive on Saturday. As such, we believe the impact of a change in delivery frequency on our subscribers and our business would be relatively small. To be clear, however, Netflix does not favor ending Saturday delivery in a vacuum; rather, it is a reasonable proposal in light of the very difficult challenges facing the Postal Service.
- We believe that additional rate increases necessary to cover the Postal Service's retiree health funding obligation will unnecessarily impact businesses and consumers that utilize the Postal Service. Companies like Netflix will either have to bear the impact of this increase or pass that cost along to its customers. In either case, we believe that these additional costs will only further exacerbate the challenges faced by the Postal Service - making their products more expensive and further negatively impacting mail volumes.

- The Postal Service has indicated that it plans to seek rate changes in 2011 due to “exceptional or extraordinary circumstances.” Netflix believes that the economic turmoil of the past few years coupled with the increasingly rapid technological changes reshaping the consumer marketplace, constitute exceptional or extraordinary circumstances. Nonetheless, we are hopeful that Congress will provide relief to the Postal Service on many of the issues discussed below, thereby minimizing the scope and extent of any necessary rate increase.

WITNESS BACKGROUND

I am currently the Chief Service and DVD Operations Officer of Netflix. In this capacity, I oversee all aspects of our DVD operations, including software and automation engineering as well as all shipping and receiving activities associated with our nationwide network of over 50 distribution centers. I am also responsible for all customer service operations which includes our call center located in Hillsboro, Oregon as well as our information technology and business intelligence groups. In total, I am responsible for the management of more than 2,500 Netflix workers.

I have worked for Netflix since 1999, serving in a variety of engineering and management roles. Prior to my current position, I served as Vice President of Operations and Vice President of Systems Development at Netflix, which included the development of all systems related to the DVD service, ERP, Customer Service and Content Purchasing. I also played a key role in developing the automation that drives the company's DVD processing and delivery.

My primary focus is to improve the company's DVD rental service by reducing service errors and lowering costs. During my tenure at Netflix, daily DVD shipments have grown from a few thousand to more than two million. Over this short period, I have helped scale our logistics system to handle high transactional volumes while keeping the systems extremely reliable, available and cost effective. For example, we have automated much of our shipping process, replacing legacy processes that manually inserted 650 DVDs into a mailer per hour with automation that inserts more than 4,000 an hour.

As the Chief Service and DVD Operations Officer, I supervise all our interactions with the United States Postal Service and as such am well qualified to represent Netflix's views on the future of the Postal Service.

COMPANY BACKGROUND

With more than 14 million subscribers, Netflix is the world's largest online subscription service streaming movies and TV episodes over the Internet and sending DVDs by U.S. mail. Netflix is a publicly traded company whose stock is listed on the NASDAQ stock market under the symbol, NFLX. For calendar year 2009, Netflix had total revenues of \$1.6 billion and has forecasted 2010 revenues to exceed \$2 billion.

Our subscribers can instantly watch unlimited movies and TV episodes streamed to their TVs

and computers and can receive DVDs delivered quickly by U.S. mail to their homes. We offer a variety of subscription plans, with no due dates, no late fees, no shipping fees and no pay-per-view fees. Aided by our proprietary recommendation and merchandising technology, subscribers can select from a growing library of titles that can be watched instantly and a vast array of titles on DVD. On average, approximately two million discs are shipped daily by U.S. mail from our distribution centers across the United States. These centers have been strategically located to optimize our fulfillment operations with that of the Postal Service, helping to provide 97% of our subscribers with delivery of their DVDs in about one business day. Additionally, as of the first quarter of 2010, over half of our subscribers instantly watched 15 minutes or more of streaming content.

Subscribers can:

- Watch streaming content without commercial interruption on their computers and TVs. The viewing experience is enabled by Netflix controlled software that can run on a variety of consumer electronics devices. These devices currently include Blu-ray disc players, Internet-connected TVs, digital video players, game consoles and other devices such as the Apple iPad.
- Receive DVDs by U.S. mail and return them to us at their convenience using our prepaid mailers. After a DVD has been returned, we mail the next available DVD in a subscriber's queue. Typically, we mail out the next available DVD on the same day as we receive a returned DVD.

Our core strategy is to grow a large subscription business consisting of streaming and DVD-by-mail content. By combining streaming and DVD as part of the Netflix subscription, we are able to offer subscribers a uniquely compelling selection of movies and TV shows for one low monthly price. We believe this creates a competitive advantage as compared to a streaming only subscription service. This advantage will diminish over time as more content becomes available over the Internet from competing services, by which time we expect to have further developed our other advantages such as brand, distribution, and our proprietary merchandising platform. Despite the growing popularity of Internet delivered content, we expect that the standard definition DVD, along with its high definition successor, Blu-ray, will continue to be the primary means by which a majority of Netflix subscribers view content for the foreseeable future. However, at some point in the future, we expect that Internet delivery of content to the home will surpass DVD as the primary means by which most Netflix subscribers view content.

We launched our DVD-by-mail rental subscription business in 1999 and expanded our business to include streaming content over the Internet in 2007. This recent expansion of our business model to include Internet streaming of content is rapidly changing the way many of our customers utilize our service. As mentioned above, as of the first quarter of 2010, over half of our subscribers instantly watched 15 minutes or more of streaming content. This was up from 38% when compared to the first quarter of 2009. Nonetheless, despite this growth in Internet streaming, our disc shipments continue to grow. For 2010, we anticipate spending approximately \$600 million on

postage, making us the largest growing first-class mailer in the country. In light of this, we continue to invest in the DVD-by-mail component of our business, strengthening our service to achieve more consistent delivery and lower costs. Given the continued growth and investment in our DVD-by-mail business and its importance to our overall company strategy, we are very much interested in assuring that the Postal Service continues to deliver reliable and affordable mail service to the nation.

POSTAL REFORM PROPOSALS

We have reviewed the Postal Service's "Ensuring a Viable Postal Service for America: An Action Plan for the Future" and the recent report from the Government Accountability Office "U.S. Postal Service: Strategies and Options to Facilitate Progress Toward Financial Viability." These reports highlight some of the difficult decisions the Postal Service and the Congress face in assuring that the Postal Service continues to deliver reliable and affordable mail service to the nation.

There is no doubt that the Postal Service is currently operating in a time of significant change. What better example than that of the Netflix service itself? Only three short years ago, Netflix's entire business was DVDs-by-mail. Our delivery of movies was totally dependent on the Postal Service. In just three short years, we have seen a significant change to our business model, with more than half our subscribers instantly watching 15 minutes or more of streaming content in the first quarter of 2010. While our mail volume is still growing, and will likely grow for some time and thereafter continue to be an important part of our business for many years, this rapid shift to Internet streaming of content is emblematic of how new technology has changed the way Americans communicate and transact business and of the challenges facing the Postal Service.

We believe the actions called for by the Postal Service will help secure its viability for many years to come and help assure that our nation continues to enjoy reliable, trusted and affordable mail service. Many of the proposals made by the Postal Service reflect sound business practices that would likely be implemented by private enterprise faced with similar challenges. While we understand the unique nature of the Postal Service as a quasi-governmental agency, we do believe it is instructive to look at some of the proposals from this perspective.

Set forth below are specific comments we have related to each of the proposals made by the Postal Service under their Action Plan for the Future:

- **Retiree Health Benefits Prefunding**

While not directly related to postal operations, the current mandates on the Postal Service with respect to retiree health care benefits payments have become so burdensome on its bottom line that this issue dwarfs nearly all day-to-day operational issues. To the extent the Postal Service does not receive relief from the hefty obligation of paying \$5.5 to \$5.8 billion per year, it will likely need to raise rates even higher than necessary to cover its ongoing operating activities. We believe that additional rate increases necessary to cover this funding obligation unnecessarily impact businesses and consumers that utilize the Postal Service. Companies like Netflix will either have to bear the impact of this increase or pass that cost along to its customers. In either case, we believe that these additional costs will only further exacerbate the challenges faced by the Postal Service - making

their products more expensive and further negatively impacting mail volumes. Allowing the Postal Service to restructure retiree health benefits payments under a “pay-as-you-go” method, comparable to what is used by the rest of government and the private sector, would improve the service’s cash flow and likely reduce pressure to raise rates above what is necessary to cover its ongoing operating activities.

We also believe that the Postal Service has made credible arguments with respect to possible overpayments to the Postal Service's Civil Service Retirement System pension fund. This type of large financial discrepancy needs to be reviewed and resolved as soon as possible to either improve the organization’s financial posture (and perhaps avoiding the necessity of implementing other service changes) or make clear that additional cost-cutting may be necessary on top of other proposals under consideration.

- Delivery Frequency

Currently, Netflix processes DVD shipments and its subscribers receive delivery of their rented DVDs six days a week. The Postal Service has proposed eliminating Saturday operations. The result of this proposal would be obvious: our subscribers would no longer receive DVDs nor would Netflix process shipments on Saturday. We believe the impact, however, on our subscribers and our business would be relatively small. In particular, we believe that those subscribers who currently rely upon Saturday postal delivery to receive and watch movies on the weekend would adjust their rental habits to account for the Postal Service’s change in delivery and would plan their DVD rental selections around the fact that mail would not arrive on Saturday. As to our Saturday shipping operations, we would revert back to our historical five-day shipping operations. Netflix only began shipping on Saturdays last year. For the nine years prior to that, we processed returns and shipped out DVDs Monday thru Friday. In light of this, we would not anticipate any material negative impact to our business arising from returning to a five-day operating schedule.

To be clear, Netflix does not favor ending Saturday delivery in a vacuum; rather, it is a reasonable proposal in light of the very difficult challenges facing the Postal Service. Netflix believes that a well-functioning Postal Service, positioned over the long haul to meet changing customer and consumer demand, is more important than maintaining current delivery frequency at the expense of the broader health and continued operational reliability of the nation’s mail service. Of course, we would want any change to delivery frequency to be implemented with significant lead time and with substantial outreach to postal users. By so doing, the Postal Service would help minimize any disruption and allow consumers plenty of time to reset their delivery expectations.

- Expanding Access

Over the past several years, the Postal Service has expanded its use of retail facilities to conduct postal business, developed innovative options for Internet use and expanded automated kiosks. These improvements, however, have largely been additive to, not in lieu of, the traditional network of physical post offices. We believe the Postal Service, like Netflix itself, should have the ability to adjust aspects of its business model to changes in technology and consumer demand.

- Workforce

By its own account, the Postal Service is going to be handling less volume in coming years and the organization's headcount would likely need to reflect that decline. Some experts have concluded that as many as 300,000 full-time employees are eligible to retire over the next ten years. The key question for the Postal Service is whether these vacancies are filled with new full-time employees or a mix of full-time and part-time employees. Netflix believes that the Postal Service, whether by collective bargaining, arbitration or legislation, would benefit from additional flexibility in its workforce to control costs while maintaining manpower capabilities sufficient to meet demand in peak delivery times.

- Pricing

The ability of the Postal Service to meet its costs with changes in pricing has been limited by numerous mandates from Congress. Although Netflix is a very large first-class mailer, we agree with the Postal Service that it should be given discretion to review pricing not only for sub-sets of a class of mail, but for the class itself. This discretion would require a change in the law to apply the cost-of-living cap on increases only to the total increases and not to each class of mail.

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- Expand Products and Services

The Postal Service has described the numerous steps it must undertake to garner approval from both its Board of Governors and the Postal Regulatory Commission before entering into customer contracts and/or introducing new services. In an era where competitors with the service are not only other shippers of physical mail and goods but also Internet-based telecommunications companies, the Postal Service needs to be nimble in competing with other options and in responding reasonably to customer needs. We have found the Postal Service to be responsive and proactive in working with us to streamline our postal operations but we also recognize that we are an unusually large mailer. Small businesses and niche business lines also deserve attention from the service in a quickly-evolving market. With respect to expanding products and services that could be offered by the Postal Service, Netflix appreciates the need to adjust business models but would nonetheless caution the Postal Service about distractions that could impact its core mission of facilitating the post of physical mail.

- Oversight

The Postal Service oversight model was modified in 2006. While there are a number of parties that share oversight responsibility, we have not experienced any problems with the established

regulatory structure. Nonetheless, we are supportive of clear roles and responsibilities and for providing the Postal Service with flexibility to adapt and respond to a rapidly changing marketplace.

CONCLUSION

On behalf of Netflix, I appreciate the opportunity to provide comments concerning the future of the Postal Service. In light of the very difficult challenges facing the Postal Service, we believe the actions called for by the Postal Service will help secure its viability for many years to come and help assure that our nation continues to enjoy reliable, trusted and affordable mail service. I look forward to your questions and would be happy to be a resource to both of your committees as you consider the future of the Postal Service.