Netflix Streaming Service Takes Aim at Traditional TV

By Ethan Tussey

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The complaints from Netflix subscribers rang loudly on Twitter and Facebook following the announcement that the online rental service would be increasing its subscription fees 60%. The reason for the price increase is simple: Netflix has set its sights on the very expensive goal of becoming a new kind of online television network. Within just four years (2007-2011), Netflix, which had made a name for itself as a DVD-by-mail home delivery service, swiftly built a popular streaming video service by obtaining licenses to over a billion dollars of content. Their investment in streaming video was the first step of the company's decade-long vision to transform itself from a disc rental company to a new form of online content channel. In realizing this objective, Netflix aims to shape the future of digital entertainment.

The key to Netflix's success has been its ability to compete with television networks for content licensing deals while offering customers the deep catalog and on-demand convenience expected from an Internet product. By combining these models, Netflix has effectively adapted subscription television for the digital age. The future success of Netflix streaming service depends on the company's ability to continue to acquire profit-making licensing deals, an increasing challenge as content providers consider renegotiating and raising the prices for their streaming-service contracts. Netflix's licensing deals will also likely determine the long-term viability of online content channels in general.

Here are five things you need to know about Netflix's streaming service:

1. Entertainment studios' early experimentation with streaming media helped build Netflix's new identity.

2. Entertainment studios pushed Netflix to concentrate on its streaming service by instituting 28-day delay distribution agreements.

3. Netflix's pursuit of streaming media inspired cable companies and cable networks to accelerate their own streaming initiatives.

4. Netflix is becoming a home for serialized content.

5. Netflix's future success will depend on its ability to meet the rising distribution expenses of streaming content.

1. Entertainment studios' early experimentation with streaming media helped build Netflix's new identity.

Netfix on iPad

The growth of the Netflix streaming catalog was largely facilitated by the company's early experimental licensing deals with studios and pay-cable networks. When Netflix made its initial licensing deals for its streaming service in 2007, the streaming video market was still dominated by "cat videos" and other amateur content; a viable business model for streaming media had yet to be established. The immaturity of the streaming market encouraged content owners to think of their streaming licensing deals as merely promotional expenses; they saw online distribution as simply a way to promote revenue-generating home entertainment options.

The studios early experimental strategy for streaming services was based on the belief that Netflix and Hulu could provide television viewers with an opportunity to "catch-up" on back seasons of on-going television programs. Television DVD box sets provided the blueprint for this approach; history had shown that when studios provided customers with back seasons of on-going TV shows via DVD viewers would eventually begin watching new episodes on traditional television. Following this logic, CBS and Disney both signed deals with Netflix in 2008 to make some of their programming available on the streaming service the day after it aired on television. Anthony Soohoo, former senior vice president and general manager of entertainment at CBS
Interactive, explained his company's online strategy at the time, stating, "Our whole belief about online is it's very complementary to what happens on television." Netflix capitalized on this studio strategy by attracting customers to their streaming service with current TV hits.

Television studios were not the only companies looking to promote their content on a streaming service. In 2008, Starz president Bill Myers said his company signed its distribution deal with Netflix in hopes of introducing its content library to a wider audience. He did not consider streaming services to be a "replacement product" for cable subscriptions when he agreed to make 2,500 films available on Netflix "Watch Instantly" in exchange for $25 to $30 million. Media analyst Michael Nathanson called it "probably one of the dumbest deals ever," because, as Time Warner CEO Jeff Bewkes offered, "Why should anyone subscribe to Starz when they can basically get the whole thing [from Netflix] for about nothing?" That deal also gave Netflix access to exclusive Disney and Sony content without having to sign contracts with those studios directly. Disney threatened Starz with litigation but Starz successfully argued that it could sell sub-licensing rights to "content aggregators" such as Netflix. As it did with the broadcast television networks, Netflix shrewdly used Starz's desire to experiment with digital streaming to gain access to premium content.

As of June 2011, Netflix CEO Reed Hastings has acknowledged that experimental moment in streaming video has passed and Netflix is now prepared to pay larger fees for licensing rights (e.g., in 2010 it signed a deal with EPIX for 3,000 films worth $1 billion). It is safe to say that Netflix would not be in a position to pay these rising licensing fees today if it had not attracted so many consumers to its streaming service earlier on.

For more about these early syndication deals read an interview with Stephan Shelanski, former Starz programming chief (link)

2. Entertainment studios pushed Netflix to concentrate on its streaming service by instituting 28-day delay distribution agreements.

Don't expect to get new release DVDs from Netflix

The entertainment studios' efforts to protect their DVD revenues ultimately helped Netflix build its streaming library and shift its focus from discs to streaming video. The studios pursued protectionist strategies once Netflix and other companies threatened to overtake the "new release" DVD window, the most lucrative segment of the content distribution chain. Studio executives have argued that rental companies like Netflix and Redbox hurt new-release revenue because they offer new releases at a discounted price. As overall DVD sales have waned, the studios have looked for ways to encourage consumers to purchase new releases rather than rent or stream. One way studios have encouraged DVD purchases has been to negotiate with Netflix to make new releases unavailable for 28 days (or in some cases, 90 days). Even though new releases are the most valuable content for Netflix's disc rental business, the company agreed to the waiting periods to maintain their distribution deals with the studios.

These waiting periods have effectively moved Netflix into the second-run syndication market, where they directly compete with pay-cable networks for content and licensing deals. In order to competitively bid for this content, Netflix had to establish its streaming service as a viable entity with diverse and desirable content. As explained by Greg Sandoval of CNET, when the studios protected their DVD revenue they simultaneously built Netflix's streaming service with discounted back catalog content. Netflix shrewdly accepted a threat to its DVD business and invested in its future as a competitive online channel. Pay-cable networks including EPIX, Showtime, and Starz, which had previously made their original programming available on Netflix's streaming service, recognized Netflix as an emerging competitor and have since instituted their own delay windows to protect and maximize profits on their own content.

For commentary on the competition between Netflix and premium cable providers, read Peter Kafka at All Things D.

3. Netflix's pursuit of streaming media inspired cable companies and cable networks to accelerate their own streaming initiatives.

HBO Go on the iPhone

The rapidly growing popularity and success of Netflix's streaming service has caused significant reaction among companies across the media industries. Netflix has complicated its partnerships with studios and cable companies by engaging in licensing and syndication deals across various distribution windows, including deals for the rights to the back catalog of individual shows, day-after rights for currently airing television series, and contracts with studios for rights to entire libraries of content. It is important to note that traditionally, each of these deals would have been designated for autonomous channels across the distribution chain, not aggregated within one service.

Cable companies are particularly concerned with Netflix's aggregation of diverse content. Before Netflix, cable and satellite companies were the only services offering a variety of content from various distribution windows. In September 2009, *Wired* ran a story with the headline "Netflix Everywhere: Sorry Cable, You're History," which claimed that Netflix had cultivated enough subscribers to be considered the third largest "cable company" in the nation. This, the author maintained, could lead consumers to drop their cable subscriptions altogether and sign up with Netflix instead. As a response, the cable companies have developed cloud-based "television everywhere" models that provide subscribers with extensive access to programming on-demand and on a variety of devices. Some experts have suggested it is belt-tightening on account of the economy and not "cord-cutting" (leaving cable/satellite subscriptions behind for online services) that is the reason cable subscriptions have been on the decline since the arrival of streaming video. Nevertheless, the cable companies are not taking any chances as they move to create services to compete with Netflix.

In an April 2011 article posted on All Things D, Peter Kafka argued that Netflix is contributing to "cord-shaving" (customers choosing to reduce the size of their cable package) more than it is inspiring cord-cutting. Premium cable networks, the same networks that had been making their content available on Netflix's streaming service, have been the targets of this new behavior, he claimed. To maintain subscribers' interest, Showtime and Starz have since instituted delays for their own original series on Netflix's streaming service, hoping audiences will still prefer immediate viewing to delayed streaming. HBO has gone one step further by launching HBO Go, its own streaming service that makes large portions of the HBO library available online to its subscribers. This value-added service is designed to give customers more flexibility in their media use. Still, HBO Go users are limited to HBO content whereas Netflix's streaming service offers content from a variety of sources. It remains to be seen if customers will leave Netflix for these new digital offerings from cable companies and cable networks.

For more on how companies are reevaluating their relationship with Netflix, read Janko Roettgers' piece in NewTeeVee.

4. Netflix is becoming a home for serialized content.

In April 2011, the same month Netflix CEO Reed Hastings declared Netflix's streaming service to be just "one more cable network," the company made licensing deals to acquire the television serials *Mad Men*, *Sons of Anarchy*, and *Glee*. Combined with its deals for *Ugly Betty*, *Brothers and Sisters*, and *Nip/Tuck*, Netflix appears to be building its own "cable network" around serialized content in particular, thereby setting itself apart from its competitors.

This focus on serials provides Netflix with a strategic advantage for content licensing. Prevailing wisdom has been that serialized content is difficult to syndicate because its continuing storylines are not conducive to the "strip" style programming used by broadcast and cable networks. In the not so distant past, studios generated significant revenue on serialized content through DVD box sets, but the DVD market has been declining since 2006. Netflix, however, offers studios an alternative revenue stream by providing a syndication home for their serialized content, which, like DVD box sets, gives viewers the ability to watch content at their own pace but with the added advantage of being cheaper and stored remotely. While cable and broadcast networks paid paltry sums for serial television syndication rights (compared to syndication fees for procedural dramas), Netflix's Chief Content Officer, Ted Sarandos claimed that Netflix is "the savior for this genre of television," willing to outbid the competition for serialized content. As of June 2011, Netflix had carved out a niche as a home for defunct serialized shows while its television network competitors competed over procedural content and sitcoms. Specializing in serialized television may help Netflix keep down its licensing costs as long as serialized shows remain cheaper than traditional syndication content and Netflix remains the primary place for studios to sell it.

In another move that signals Netflix's dedication to serialized content, Netflix announced in March 2011 that it would begin producing an original online series based on the U.K. serial *House of Cards*. Netflix made a previous foray into producing original content with its failed experiment Red

Envelope, a financing arm designed to produce low budget films to be distributed by the company. Red Envelope stopped operating in 2008; three years later Netflix switched its production goals from making independent films to making serialized television shows. The transition from film production to television serial production reflects Netflix's efforts to compete with television networks as an online content channel. If Netflix successfully pioneers a serial based syndication network, it could provide a significant financial incentive for entertainment studios that might otherwise pass on expensive and complicated serial dramas.

For analysis of Netflix's production plans, read Tristan Louis' piece in Business Insider (link)

5. Netflix's future success will depend on its ability to meet the rising distribution expenses of streaming content.

Netflix's streaming video costs are rising dramatically as they compete with conglomerate-owned cable and broadcast networks for licensing and syndication rights. Analysts from Wedbush Securities have estimated that Netflix's streaming costs will rise by $500 million in 2011 and reach $1.9 billion in 2012. Netflix CEO Reed Hastings has offered several solutions for meeting the rising cost of streaming deals, including new subscription models, reduced distribution costs, and international expansion.

Hastings had reassured customers that raising subscription fees would be the last resort for generating additional revenue but in

July 2011 Netflix apparently reached this breaking point and raised its prices. Netflix had pursued other revenue generating plans including efforts to attract new subscribers from existing subscribing households. Netflix believes increasing the personalization options of its service can translate to multiple accounts per household because users will want their own account with their own recommendations and user data. The company also hopes that increasing the number of subscription tiers will attract new subscribers: In November 2010, Netflix began offering “streaming only” accounts among other new tiers in order to give customers more ways of joining. According to a Netflix press release, the July 2011 decision to separate its DVD and streaming services was made to “better reflect the costs” of each service. The move suggests that the streaming service, once considered an added value service, has matured and is now as costly as the disc rental service.

Netflix’s distribution expenses are a motivating factor that led to the decision to raise its subscription fees. The rental company had long maintained that as customers adopted the streaming service they would rent less discs and this would lower the postage costs of all those red envelopes. While Netflix processes more streaming content than discs, the postage savings does not appear to be enough to meet distribution expenses. This is particularly true as more streaming customers increases Netflix’s bandwidth costs. Currently Netflix is benefiting from some inefficiencies in the streaming infrastructure. Reports from March 2011 show that Netflix’s online distribution costs have decreased by half from 2009-2011 despite the rising popularity of its streaming service. The reduction in streaming costs is apparently due to Internet service providers (ISPs) that consistently stream below optimal levels, putting less strain on Netflix's bandwidth and subsequently reducing distribution costs. Eventually ISPs will provide more consistent service and Netflix will feel the full cost of streaming HD content to its many customers. Netflix is preparing for this eventuality by separating its streaming service from its DVD service and raising subscription fees.

Netflix has also targeted international markets as a way to increase revenues and pay for their streaming service. As of early 2011, the company has been operating in Canada and has plans to expand to the UK, Spain and 43 Countries in Latin America and the Caribbean in 2012. In an effort to manage its costs, Netflix is only offering its streaming services in most of these countries. Even still, international expansion means new costs like signing Paramount to a Canadian syndication deal. International expansion also means new competitors, as streaming services now exist throughout the world. In fact, Disney has already signed a licensing deal with LOVEFiLM, called the "Netflix of Europe," which was purchased in January 2011 by online retailer Amazon. As Netflix continues to grow internationally it will compete with other streaming services like Amazon and Apple. Competition with these technology companies could easily drive up expenses further for both Netflix and its consumers.

For an extensive interview with Reed Hastings on the plans for Netflix's future, see Henry Blodget and Dan Frommer's article in

Business Insider.