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# Netflix's Move Onto the Web Stirs Rivalries

By TIM ARANGO and DAVID CARR

In a matter of months, the movie delivery company Netflix has gone from being the fastest-growing first-class mail customer of the United States Postal Service to the biggest source of streaming Web traffic in North America during peak evening hours.

That transformation — from a mail-order business to a technology company — is revolutionizing the way millions of people watch television, but it's also proving to be a big headache for TV providers and movie studios, which increasingly see Netflix as a competitive threat, even as they sell Netflix their content.

The dilemma for Hollywood was neatly spelled out in a Netflix announcement Monday of a new subscription service: $7.99 a month for unlimited downloads of movies and television shows, compared with $19.99 a month for a plan that allows the subscriber to have three discs out at a time, sent through the mail, plus unlimited downloads. For studios that only a few years ago were selling new DVDs for $30, that represents a huge drop in profits.

"Right now, Netflix is a distribution platform, and has very little competition, but that's changing," said Warren N. Lieberfarb, a consultant who played a critical role in creating the DVD while at Warner Brothers.

For the first time, the company will spend more over the holidays to stream movies than to ship DVDs in its familiar red envelopes (although it is still spending more than half a billion dollars on postage this year). And that shift coincides with an ominous development for cable companies, which long controlled home entertainment: for the first time in their history, cable television subscriptions fell in the United States in the last two quarters — a trend some

attribute to the rise of Netflix, which allows consumers to bypass their cable box to stream movies and shows.

Netflix now has the frothy stock price to show for its success. The stock has enjoyed a Google-like rise, nearly quadrupling from its 52-week low in January, and with a market value of nearly $10 billion, Netflix is now worth more than some of the Hollywood studios that license movies to it.

In some ways, the closest parallel as a one-stop digital marketplace is iTunes, the Apple service that has put itself at the center of the digital world and has used that power to demand concessions from its suppliers.

“How did Hollywood end up supplying Netflix in the first place, particularly a product that was given to them on a flat-rate, wholesale basis?” said Jonathan A. Knee, a media investment banker and co-author of “The Curse of the Mogul.”

As recently as a few years ago, Netflix didn’t look like a case study in success: if anything, it seemed to be just the latest media company destined to be run over by technology.

From the company’s beginning in 1997, Reed Hastings, the chief executive and co-founder, had always thought of Netflix as an entertainment distribution service rather than a mail-order company, and by 2000, the company was experimenting with delivering movies over the Internet. In 2003, Netflix came up with a hardware solution, a $300 hard drive that would download films. But slow speeds — it could take six to eight hours to download a feature length film — doomed that effort. (Mr. Hastings declined to be interviewed for this article.)

But the advent of streaming — watching video in real time as opposed to downloading — gained prominence in 2005 with the explosive success of YouTube. Mr. Hastings decided that software, not hardware, was the key to delivering films over the Internet and pushed to develop high-quality streaming technology. Pricing remained an issue, however, and in a move that gave Netflix a big head start, the company decided to give the service away to existing mail-order customers.

Netflix now has more than 16 million subscribers. The company does not release figures on the most popular films or television shows streamed, but as a general rule, films that can be

streamed instantly are not fresh out of theaters or plucked from the current TV season. People who want to relive past seasons of “The Office” can do so instantly, but if they are looking for the current season — or any season of “Mad Men” — they are out of luck.

“We are very proud to announce that by every measure we are now a streaming company, which also offers DVD-by-mail,” Mr. Hastings recently told Wall Street analysts.

Just as important, Netflix arrived with an open checkbook at a time when the film industry’s main source of profits, the sale of DVDs, was plummeting.

“As the home entertainment industry comes under pressure, they are the only guy standing there in a red shirt writing checks,” said Rich Greenfield, an analyst at BTIG Research. “That makes Netflix really unique right now.”

The biggest check came a few months ago, when the company spent nearly $1 billion to stream movies from three Hollywood studios — Paramount, MGM and Lionsgate.

Steve Swasey, the company’s vice president for communications, said, “As we move from paying U.S. postage to acquiring movies and television episodes from the studios and networks, Netflix can become one of their top customers.”

But digital economics can be much less lucrative to content companies. For example, under the terms of Netflix’s deal with Starz, the pay-TV channel, which allows Netflix to stream movies from Sony and Disney, Netflix pays about 15 cents a month for each subscriber, much less than the $4 to $5 a month that cable and satellite owners pay for access to Starz, according to research by Mr. Greenfield.

For that reason, Netflix is increasingly viewed as a threat by cable companies and movie studios, who are considering a variety of ways to put the brakes on the company’s growth.

For example, big media companies like Time Warner are moving quickly to offer their own streaming products. Studios have pushed back on release dates, requiring Netflix to wait through a window of 28 days while studios pushed more expensive and lucrative sales of the DVD and on-demand versions on cable.

And the studios are positioning themselves to demand more money in future negotiations over

streaming rights, especially next year when Netflix's deal with Starz expires.

"Though already a significant customer, they've grown faster than anyone anticipated, and going forward we expect the economics to improve significantly," said John Calkins, executive vice president of digital and commercial innovation at Sony Pictures Home Entertainment.

For now, Netflix has become a barometer of the apparently voracious consumer appetite for streaming movies: a recent study by Sandvine, a broadband equipment maker, showed that Netflix, surprisingly, accounted for more than 20 percent of all Internet download traffic in North America in peak evening hours.

"Netflix used an open-source network, the U.S. Postal Service, to launch an alternative distribution business without asking anyone for permission," said Tim Wu, a Columbia University law professor and author of "The Master Switch: The Rise and Fall of Information Empires." "Now they are using another open-source network, the Internet, to transform the business. It is much easier for Netflix to change, because they don't have to undergo a kind of religious conversion like media companies will have to."