THE WALL STREET JOURNAL.
WSJ.com

TECHNOLOGY

DECEMBER 6, 2010

No Longer Tiny, Netflix Gets Respect—and Creates Fear

As Rivals Look to Counter Its Online Movie-Streaming Service, Hollywood Cautiously Cuts Deals to Provide Some Content

By NICK WINGFIELD and SAM SCHECHNER

After years as a bit player in entertainment, Netflix Inc. is being eyed for a new role by Hollywood: industry hulk.

The Silicon Valley company has successfully expanded its mail-order DVD rental service to delivering video online. Meantime, the rise of Internet-connected TVs and disc players means that Netflix's electronically streamed movies and TV shows are reaching living rooms, not just computers.

All that poses a potential threat to the traditional way consumers watch movies and TV: cable, phone and satellite systems.

Netflix had 16.9 million subscribers at the end of September, up 52% from a year earlier.

Meantime, over the past two quarters, the number of U.S. households that subscribe to cable and other paid TV services fell for the first time since the dawn of cable—by about 335,000 households out of about 100 million, according to data provider SNL Kagan.

Time Warner Inc. said last month it expects its HBO pay-TV service to lose 1.5 million subscribers this year, though it blamed the decline on the poor economy and changes in promotions, not on consumers replacing cable subscriptions with Web video, a practice dubbed "cord-cutting."

Netflix's growth surge—at a time of weak DVD sales and increasingly fragmented TV audiences—prompts concern among movie and TV studios as well as other technology companies. One big worry is that the company could end up dominating the electronic distribution of movies and TV the way Apple Inc.'s iTunes Store dominates music.

To prevent that, entertainment and technology companies are exploring plans to outflank Netflix with their own offerings.

Amazon.com Inc. is developing a Netflix-like subscription service that would offer TV shows and movies, according to people familiar with the matter. That service would be included as a bundle with its Amazon Prime shipping service, which costs $79 a year, those people said. An Amazon spokesman didn't respond to a request for comment.

Media companies, meantime, have talked to Microsoft Corp. and Sony Corp., both of which provide access to Netflix's streaming service through their videogame consoles, about licensing TV shows directly to the two companies for offering through subscriptions, said people briefed on the conversations.

A spokesman for Microsoft, which already cut one such deal with Walt Disney Co.'s ESPN, declined to comment. A Sony spokesman didn't respond to a request for comment.

TV maker Vizio Inc. also has expressed interest securing video content for a subscription service, according to people familiar with the talks. A Vizio spokesman declined to comment.

And OnLive Inc., a startup that delivers videogames over the Internet, plans to offer movies next year through a subscription service and other pricing schemes. One of OnLive's major investors is Time Warner's Warner Bros. studio.

OnLive CEO Steve Perlman said the entertainment companies are worried that Netflix could develop too much control over online video. "I think 'concerned' is a gross understatement," said Mr. Perlman. "There's a snowball effect. At some point they [Netflix] have so much content, if you want to get your stuff distributed you have to go with them."

Some media executives hope that competition for content among tech companies will inspire an arms race that will bid up the value of their offerings. "We're always in favor of a vibrant, competitive ecosystem," said Zander Lurie, senior vice president of strategic development at CBS Corp.

Ted Sarandos, Netflix's chief content officer, believes entertainment companies overall see his company as a good partner. For one thing, Netflix is paying them large sums for their movies and TV shows. In August, Netflix agreed to pay about $1 billion over five years to Epix, a pay-TV channel owned by Viacom Inc., Lions Gate Entertainment Corp. and Metro-Goldwyn-Mayer Studios Inc., for Internet rights to films and TV shows.

Mr. Sarandos said entertainment companies are aware of the risks associated with online video distribution, so they are moving carefully. "They're trying to be mindful of what it means in the long term," he said. "There are various concerns when you see big shifts in consumer behavior."

An obvious issue is that online video distributors could undermine existing cable-and satellite television services by providing an inexpensive alternative. (Net flix's subscription plans start at $7.99 a month). If a significant number of households trade down to cheaper monthly bills, it could jeopardize the more than $30 billion a year media companies reap from traditional distributors.

In part to head off customer defections, several major TV-service providers including Time Warner are putting their cable shows online—but only for their own subscribers—a concept often called "TV Everywhere."

Pay-TV movie channels such as HBO, CBS's Showtime, and Liberty Media Corp.'s Starz could face the most direct competition from Netflix. Time Warner, which also owns basic-cable networks and the Warner Bros. studio, views new online distributors like Netflix as both "potential partners" and possible "competitors to us and other content companies," a spokesman said.

Time Warner's approach is to be careful with what content it licenses. In July, for instance, Warner Bros. sold Netflix a package that included TV shows that it had trouble selling in TV's traditional "syndication window" for rebroadcasting. But big moneymakers like "Two and a Half Men" aren't included.

"It's important that we sell the right content, in the right window, for the right price," the Time Warner spokesman said.

Starz, for its part, has a conflicted view of Netflix, said a person familiar with its thinking. The company struck a deal with Netflix several years ago that lets it stream movies Starz licensed from studios like Disney and Sony, an agreement that expires next year. But Starz executives also recognize Netflix could compete for subscribers and eventually attempt to cut Starz out of the loop by making direct deals with Hollywood studios, this person said.

Since the beginning of last year, the company's share price has risen more than six-fold, leaving it with a market value of around $10 billion.

Write to Nick Wingfield at nick.wingfield@wsj.com and Sam Schechner at sam.schechner@wsj.com