

'Throttling' Angers Netflix Renters

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SAN FRANCISCO (AP) - Manuel Villanueva realizes he has been getting a pretty good deal since he signed up for **Netflix** Inc.'s online DVD rental service 2 1/2 years ago, but he still feels shortchanged. That's because the \$17.99 monthly fee that he pays to rent up to three DVDs at a time would amount to an even bigger bargain if the company didn't penalize him for returning his movies so quickly.

Netflix typically sends about 13 movies per month to Villanueva's home in Warren, Mich. -- down from the 18 to 22 DVDs he once received before the company's automated system identified him as a heavy renter and began delaying his shipments to protect its profits.

The same **Netflix** formula also shoves Villanueva to the back of the line for the most-wanted DVDs, so the service can send those popular flicks to new subscribers and infrequent renters.

The little-known practice, called "throttling" by critics, means **Netflix** customers who pay the same price for the same service are often treated differently, depending on their rental patterns.

"I wouldn't have a problem with it if they didn't advertise `unlimited rentals,'" Villanueva said. "The fact is that they go out of their way to make sure you don't go over whatever secret limit they have set up for your account."

Los Gatos, Calif.-based **Netflix** didn't publicly acknowledge it differentiates among customers until revising its "terms of use" in January 2005 -- four months after a San Francisco subscriber filed a class-action lawsuit alleging that the company had deceptively promised one-day delivery of most DVDs.

"In determining priority for shipping and inventory allocation, we give priority to those members who receive the fewest DVDs through our service," **Netflix**'s revised policy now reads. The statement specifically warns that heavy renters are more likely to encounter shipping delays and less likely to immediately be sent their top choices.

Few customers have complained about this "fairness algorithm," according to **Netflix** CEO Reed Hastings.

"We have unbelievably high customer satisfaction ratings," Hastings said during a recent interview. "Most of our customers feel like **Netflix** is an incredible value."

The service's rapid growth supports his thesis. **Netflix** added nearly 1.6 million customers last year, giving it 4.2 million subscribers through December. During the final three months of 2005, just 4 percent of its customers canceled the service, the lowest rate in the company's six-year history.

After collecting consumer opinions about the Web's 40 largest retailers last year, Ann Arbor, Mich., research firm ForeSeeResults rated **Netflix** as "the cream of the crop in customer satisfaction."

Once considered a passing fancy, **Netflix** has changed the way many households rent movies and spawned several copycats, including a mail service from Blockbuster Inc.

Netflix's most popular rental plan lets subscribers check out up to three DVDs at a time for \$17.99 per month. After watching a movie, customers return the DVD in a postage-paid envelope. **Netflix** then sends out the next available DVD on the customer's online wish list.

Because everyone pays a flat fee, **Netflix** makes more money from customers who only watch four or five DVDs per month. Customers who quickly return their movies in order to get more erode the company's profit margin because each DVD sent out and returned costs 78 cents in postage alone.

Although **Netflix** consistently promoted its service as the DVD equivalent of an all-you-can eat smorgasbord, some heavy renters began to suspect they were being treated differently two or three years ago.

To prove the point, one customer even set up a Web site -- <http://www.dvd-rent-test.dreamhost.com> -- to show that the service listed different wait times for DVDs requested by subscribers living in the same household.

Netflix's throttling techniques have also prompted incensed customers to share their outrage in online forums such as <http://www.hackingnetflix.com> .

"**Netflix** isn't well within its rights to throttle users," complained a customer identified as "annoyed" in a posting on the site. "They say unlimited rentals. They are liars."

Hastings said the company has no specified limit on rentals, but "'unlimited' doesn't mean you should expect to get 10,000 a month."

In its terms of use, **Netflix** says most subscribers check out two to 11 DVDs per month.

Management has previously acknowledged to analysts that it risks losing money on a relatively small percentage of frequent renters. The risk has increased since **Netflix** reduced the price of its most popular subscription plan by \$4 per month in 2004 and the U.S. Postal Service recently raised first-class mailing costs by 2 cents.

Netflix's approach has paid off so far. The company has been profitable in each of the past three years, a trend its management expects to continue in 2006 with projected earnings of at least \$29 million on revenue of \$960 million. **Netflix's** stock price has more than tripled since its 2002 initial public offering.

A September 2004 lawsuit cast a spotlight on the throttling issue. The complaint, filed by Frank Chavez on behalf of all **Netflix** subscribers before Jan. 15, 2005, said the company had developed a sophisticated formula to slow down DVD deliveries to frequent renters and ensure quicker shipments of the most popular movies to its infrequent -- and most profitable -- renters to keep them happy.

Netflix denied the allegations, but eventually revised its terms of use to acknowledge its different treatment of frequent renters.

Without acknowledging wrongdoing, the company agreed to provide a one-month rental upgrade and pay Chavez's attorneys \$2.5 million, but the settlement sparked protests that prompted the two sides to reconsider. A hearing on a revised settlement proposal is scheduled for Feb. 22 in San Francisco Superior Court.

Netflix subscribers such as Nathaniel Irons didn't believe the company was purposely delaying some DVD shipments until he read the revised terms of use.

Irons, 28, of Seattle, has no plans to cancel his service because he figures he is still getting a good value from the eight movies he typically receives each month.

"My own personal experience has not been bad," he said, "but (the throttling) is certainly annoying when it happens."

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