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Netflix Is Not Facing The Innovator's Dilemma

Timothy B. Lee 9/19/2011

It’s now apparent why Netflix changed its pricing structure a few weeks ago, making streaming and DVDs separate products with separate pricing. The company has announced that it is spinning off its DVD-rental business as a separate company, called Qwikster. The original company will carry on as a streaming-only firm.

Netflix CEO Reed Hastings has a blog post in which he suggests his basic motivation is to avoid running afoul of the innovator’s dilemma, which I’ve written about before. But the rationale he offers in that post—that the DVD business might hold back the streaming business—doesn’t make a lot of sense.

A service like Netflix faces a fundamental chicken-and-egg problem. You can’t get an established base of users unless you have a fairly complete library—users aren’t going to be very interested in a service that only has half the movies they want to watch. But if you don’t have a large user base, you don’t have much leverage against major content providers, who are going to hold back their best content as leverage to get terms favorable to themselves.

Luckily, the classic, DVD-based version of Netflix had an ace in the hole: copyright’s First Sale Doctrine. If a studio wasn’t willing to license its content to Netflix directly, Netflix simply went out and purchased copies of DVDs at retail. Renting out your legally-purchased copy of a DVD isn’t copyright infringement, so there was nothing the studios could do to stop this. And this strengthened Netflix’s position at the bargaining table, because they could credibly threaten to walk away from the table if the studios made unreasonable demands.

This became crucially important as Netflix moved into the streaming era. There is no equivalent to the First Sale doctrine for online streaming. If you want to run a streaming service, you have to cut a deal with each copyright holder whose content you want to stream. And Hollywood, fearful of losing control and undermining its existing revenue streams, has been cagey about allowing Netflix to stream its best content.

The DVD-rental option gave Netflix a crucial fallback position at the negotiating table. Because Netflix has a complete catalog of movies available for rent by DVD, they don’t *need* any specific title in streaming format. So they could cut deals with the content

creators that offered them reasonable terms, and stick with DVD rentals for the rest. That's a little bit inconvenient for customers, but it's better than agreeing to terms that would force Netflix to jack up its prices.

And, of course, the total size of Netflix's user base strengthens its bargaining position as well. There are many customers like us who primarily subscribe to Netflix for the DVDs, but we're willing to pay a bit extra for the streaming option. A Netflix with 20 million customers—DVD and streaming—is going to be able to make bigger bids for streaming content than a streaming-only company with 10 million customers.

Inexplicably, Reed Hastings seems determined to throw these advantages away, leaving streaming to fend for itself. There's a real danger this will result in a death spiral: the new, smaller company will have trouble landing content deals, or will be forced to raise prices in order to cover the costs of content. This will make the service less attractive to customers, some of whom will cancel their subscriptions, making it even harder to get content.

Hastings implicitly invokes Clay Christensen, but it's hard to see how Netflix's streaming business could be run in a disruptive fashion. Disruptive technologies work by undercutting the incumbents' business model, but Netflix is about to make itself a lot more dependent on the goodwill of those same incumbents.