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INTRODUCTION

As the 1979 hit song by The Buggles states, "video killed the radio star." Coincidentally, since the early-2000s, there has been speculation that the television industry may be on the cusp of its own extinction-level event, with streaming sites such as Netflix acting as the meteor. Scholars such as Lotz (2014) and Strangelove (2015) refute that theory, proposing instead the idea of 'post-legacy' television¹. Strangelove (2015, p.4) notes: "the 'post' in 'post-TV' does not indicate the end of television itself, but does refer to the end of a particular way in which broadcast television structured viewing and the beginning of new ways of participating in television."

Enter Netflix. Since its founding in 1997, the company has evolved from an online Blockbuster to the name brand in online streaming services and "world's leading Internet television network", with 93 million subscribers in 190 countries (Netflix 2017a). In many ways, the company has mapped the same trajectory as cable network HBO did in the 1990s- developing from an aggregator of first-run cinema and event content to the connoisseur of quality television- and prompting the slogan "It's not TV. It's HBO" (HBO ca.1998 cited by Miller 2008, p.ix). Now, with an expanding line-up of award-winning content², the adage is increasingly "It's not TV. It's Netflix." Still, the company has begun to experience its version of what Miller (2008) identified as the post-"Sopranos" pressure that befell HBO in the late-2000s when other channels began to adopt its specialty as their own. Netflix, despite its first- mover status, is now facing competition from other aggregators, as well as legacy television networks migrating to the online sphere. Looking forward, this essay will examine the business model currently used by Netflix, focusing on the aspects of production/distribution, content creation and acquisition, and recovery of costs (Picard 2011), particularly surrounding its original series. It will outline the company's strengths and weaknesses regarding its use of metadata and analytics in acquisition; methods of financing and distributing content; and sources of revenue.

EVOLUTION OF THE NETFLIX BUSINESS MODEL

When Netflix was founded in the late 1990s, its initial business model was based solely upon the rental and postal distribution of DVDs from an online catalogue on a à-la-carte basis. However, it quickly changed its payment model from pay-per-use (Picard 2011, p.34) to a monthly subscription allowing unlimited rentals to better compete with established firms. By the time of its initial public offering in 2002 the company had 600,000 members; as of 2005, this had grown to 4.2 million (Netflix 2017a), with the company shipping more than one million DVDs per day (The Economist 2005). This overall model remained the same until 2007, when Netflix debuted online streaming alongside its domestic postal service, allowing subscribers to instantly watch movies and television series on their computers (Netflix 2017a). The company continued to evolve over the next six years, expanding from a domestic distributor of physical media content to an international distributor of online media content. The final alteration to the company's business model came in 2013 when Netflix moved into the production sphere with its first original series, "House of Cards".

Apart from being a purveyor of aggregated content, Netflix's model is now increasingly defined by its operations as a distributor and producer (Picard 2011, p.33) of original series. According to the company's Chief Financial Officer David Wells, Netflix is aiming to produce 50% of its own programming over the next several years, with plans to spend \$6 billion on both licensed and original content in 2017 alone (Powell 2016). This reflects changes in the market lifecycle, but also the particular position occupied by Netflix as a subscription service with limited secondary revenue streams. Picard (2011, p.34) notes "as the environment in which a firm or industry changes, so do the factors that support a business model." The video-on-demand (VOD) market has reached what McGahan et al. (2004 cited Cunningham and Silver 2013, p.2-3) characterise as the "shakeout" stage, in which the number of viewers willing to pay for content has begun to develop critical mass, forcing platforms to invest in new content. While the nature of this content isn't specified, Vogel (2015, p.154) acknowledges that the "proliferation of other ways to watch movies...has led pay-channel service providers to...become less dependent on Hollywood features." The same can be said of streaming services. In the case of Netflix specifically, Robert Thompson, director of Syracuse University's Blieir Centre for Television and Popular Culture, surmises "the people who want [it] for the movies and old shows...by now, they've subscribed" (Powell 2016). Therefore, it's essential that the company moved into original series, otherwise it risked losing subscribers in accordance with the law of diminishing marginal utility; defined by Barrett (1974, p.79), utility is a "measure of the desirability of a commodity from the psychological viewpoint of the consumer", with diminishing marginal utility "[suggesting] that the more of a given product an individual consumes, the less satisfaction they will derive from successive units" (Doyle 2013, p.4). For Netflix, which relies almost solely on subscriptions for its revenue, there is increased pressure to maintain its audience. If subscribers feel there is nothing remaining for them to watch, they are likely to cancel, impacting the company's bottom line. However, as Thompson acknowledges "each original program wears away at the resistance of those people who have not subscribed yet" while further engaging the current viewers (Powell 2016), but only if the content is of interest to them.

CONTENT CREATION AND ACQUISITION

As noted, a defining element of Netflix's current business model, and perhaps the one most central to its ongoing success, is the company's provision of premium original series, or what Lotz refers to as "prized content". Separate from simply what is available through linear viewing, she characterises this as content that is "deliberately pursued", programming that "compels some audience members...to seek out missed episodes, control viewing, and even pay" (Lotz 2014, p.12). Lotz acknowledges, however, that it is not necessarily what would be considered 'hit television' in terms of total viewing numbers, often skirting the line between mass and niche; rather, what makes it "prized" is the passion of its viewers (2014, p.13). Although not all of Netflix's series meet these criteria, the majority do- a direct result of one of the business's foundations and overall key strengths: its collection and analysis of subscriber metadata.

Data-Driven Acquisition

Prior to introducing its original content, Netflix's competitive advantage was its personalisation features, namely its recommendation algorithm (Alexander 2016). Worked on by 800 engineers, the algorithm monitors hundreds of millions of 'events' per day, logging these "discrete actions" - when each user pauses, rewinds, or fast-forwards a movie or series (Leonard 2013)- as well as other elements of behaviour such as time spent browsing, and similarities in viewing patterns with regard to content specifics like the director, actors, and release date (Vanderbilt 2013). While originally this metadata was only used to provide subscribers with programming suggestions, its analysis has become an integral part of the company's acquisition process, mirroring the film industry's use of 'Monte Carlo' statistical methods to determine the correct mix of variables (stars, director, running time, etc.) to ensure a profit (Vogel 2015, p.158). According to the company's Chief Communications Officer Jonathan Friedland:

"We know what people watch on Netflix and we're able with a high degree of confidence to understand how big a likely audience is for a given show, based on people's viewing habits."

This understanding led the company to bid \$100 million for "House of Cards", with data indicating a large cross-section of subscribers who'd enjoyed the original BBC series, as well as films starring Kevin Spacey and those directed by David Fincher (Leonard 2013). The series has continued to be popular for Netflix, ranking as the most-watched show in the 30 days following its third season premiere, with a 6.4% share of total subscribers (Wallenstein 2015). More recently, the company has also seen success from "Fuller House", which was viewed by over 21 million in its first 35 days of availability (Shepherd 2016), and helped Netflix gain 6.7 million new subscribers in the first quarter of 2016 (Powell 2016). The company's decision to green-light the series, despite most broadcast networks turning it down (Nededoge 2016), reflects what Doyle (2013, p.103) identifies as "repetition and imitation", or capitalising on features already proven popular with audiences (Bielby and Bielby 1994) and designed to exploit their loyalty (Hoskins et al. 1997). Many of Netflix's original series share this attribute, in terms of characters ("Gilmore Girls: A Year in the Life"), storylines (Marvel Cinematic Universe extensions), or format (serial "Making a Murderer"). As with "House of Cards" and Kevin Spacey, some also feature well-known actors, including "Grace & Frankie" (Jane Fonda and Martin Sheen) and "The Unbreakable Kimmy Schmidt" (creator Tina Fey), thus ensuring instant promotability (Marich 2005). This demonstrates not only the effectiveness of the

algorithm to identify audience interests, but also the strength of Netflix's business model to bring corresponding ideas to fruition, an aspect that will be discussed further with regard to financing and recovery of costs.

In addition to giving Netflix a distinct advantage over competitors in terms of responding to preferences in accordance with audience 'pull' rather than supplier 'push' and gauging the potential performance of programming when commissioning new series, the use of metadata allows the company to save money by those same standards. For legacy television networks, who often develop 20 'pilot' productions per year (of which 10% may get a series order), the consequences of not ordering a series can be high; for 'put pilot' deals, the fee can be between \$250,000 to \$500,000, increasing to over \$1 million for a cancelled order (Vogel 2015). According to Littleton (2014), the cost of pilot season research and development for each of the top four American television networks is approximately \$80-100 million per year. By contrast, although Netflix pays high upfront fees, the company does not have to commission pilots, as it only bids on shows for which it knows there's an audience (Rose 2014). Likewise, rather than rely on Nielsen or the Broadcast Audience Research Board ratings, which can estimate but not state actual viewing numbers or audience (Arnold 2016, p.49), metadata allows Netflix to accurately track the performance of a program from its debut and make decisions on renewal or cancellation according to subscriber engagement (Rose 2014). In that vein, the company recently announced the termination of 13th century epic "Marco Polo" after just its initial two-season order. The show was estimated to have a budget around \$180 million (\$90 million per season), and filmed internationally (Koblin 2016). However, it failed to secure a dedicated audience for its second season, a rarity for Netflix, but one that critics of its evolving algorithm have anticipated.

While Netflix's recommendations were initially based solely on viewing of aggregated content, the algorithm now takes into account the company's expanding roster of original series. Given estimates that 75% of user traffic is driven by the algorithm (Vanderbilt 2013), the company's use of metadata gives it the opportunity to both "profile and control the behaviour" of its subscribers (Arnold 2016, p.50), and push viewers toward certain content. Netflix has admitted to using this type of 'in-app marketing' to position shows, noting that the higher up the page and to the left a piece of content is, the more likely it will be played (Vanderbilt 2013). Although an analysis of user data should keep this from impacting recommendations too severely, if a user continues to engage with the content, the algorithm becomes self-fulfilling. However, it fails to take into account the affinity subscribers have for a series they watched out of interest or convenience versus intent; for example, in looking at over-the-top (OTT) usage of over one million Netflix subscribers worldwide, data intelligence provider 7Park Data found that "library" content and older seasons of current shows outperform Netflix's original series in overall viewing- despite the original series driving subscriptions- with sitcoms being the most popular. The company's CEO, Brian Lichtenberger, notes that this is because the 30-minute format is "highly bingeable" and this has had "a direct impact on the type of content being consumed" (Cromwell 2016). Overall, while a user's recommendations still reflect their own taste, they are also a "product of...Netflix's authority to create that user's taste" in keeping with its own interests, but in contrast to its position as poster child for the long tail (Smith-Rowsey 2016, p.63-66).

Impact on the Long Tail

When discussing Anderson's (2006) long tail, Netflix was originally considered a case study for the argument and in theory, the company's subsequent move to VOD should support the long tail better than its DVD service (Salmon 2011). However, as its business model has further evolved to prioritise original series- incurring increased costs against its subscription revenue- it's questionable whether continued investment in niche content, particularly those aggregated series or movies which are rarely viewed, can be justified. While Netflix does take a "curatorial approach", it's one that is consumer focused, rather than archival (Kenny 2016). The cost of a television program or film is not affected by the number of people who watch it (Doyle 2013), but when considered in terms of a subscription service like Netflix- where viewers are not paying for a specific show but a variety of shows- the value of such content is minimal and the service is unlikely to lose revenue from removing it. Still, this argument only applies to what would be considered niche content within Netflix, as many of its own original series meet these same criteria by legacy television standards, despite accounting for 15-23% of the site's monthly views (Cromwell 2016).

PRODUCTION AND DISTRIBUTION

As a first mover in VOD and original content, Netflix has both impacted and benefited from what Doyle (2016, p.77) describes as the "digitisation and [internet growth] that has altered the modes of distribution and consumption of television," shifting audiences and financial power away from legacy television. By continuing to innovate, the company has allowed itself to remain competitive (Baumol 2002) against both these networks and fellow VOD services, maintaining control of content and audiences through the way it finances and distributes.

Cost-Plus Financing

Characterised by the company as "straight-to-series", Netflix has consistently utilised cost-plus financing when commissioning its original content (Rose 2014). The model comprises the distributor covering the entire production budget for a program upfront, as well as paying the production company an additional profit of approximately 10% of the fee. In return, it acquires the primary rights to transmit the program, as well as secondary, or windowing rights, including DVD retail, online distribution, and overseas sales (Doyle 2013, p.112). By purchasing the content outright, Netflix has been able to protect its unique selling point- the exclusivity of its original series to the platform- as well as any subsequent revenue streams. In continuing to employ this model, the company has set a precedent that has been beneficial in terms of acquiring new content, receiving pitches from scriptwriters before the Hollywood studios (Strangelove 2015, p.151). This reputation also extends internationally, with the CEO of British production company KEO Films acknowledging the draw:

"We'd love to produce something directly for [Netflix]...you know they are going to want worldwide rights for a significant amount of time if not forever...the quid pro quo is that [they] tend to pay the full cost of production plus a decent margin" (Doyle 2016, p.88).

However, while cost-plus allows Netflix access to a range of prospective content, it also has a potentially detrimental impact on its financial margins.

Day-and-Date Distribution

With the launch of its online streaming service in 2007, Netflix normalised binge watching, allowing subscribers to easily consume multiple episodes consecutively. As the company moved into original series, this idea of instant access continued, leading to what has become the defining characteristic of Netflix's distribution model: the day-and-date release of its content across all territories (McDonald and Smith-Rowsey 2016, p.4). So far, this has proven beneficial, generating the type of speculative publicity normally reserved for theatrical premieres. In creating an event atmosphere around its releases Netflix is able to generate a significant amount of social media buzz and potentially a larger audience, with Nielsen identifying a strong correlation between online conversations, or electronic word of mouth, and viewing numbers (Strangelove 2015, p.139). This reflects growth already seen in terms of subscriptions, with Netflix (2016) acknowledging that the majority of users sign up in its fourth and first quarters when the company premieres most of its new shows, as well as echoes De Vany's (2004, p.41) assessment that "opening performance is a statistically dominant factor in revenue generation." The move also helps protect downstream revenues from piracy, which Netflix (2017b) notes "could become its largest competitor moving forward." By releasing content everywhere simultaneously, it minimises the likelihood of audiences pursuing access through alternative sources, a practice most avoid if there is a legal option (Lindsey 2016). However, by the same token, this has also curtailed Netflix's ability to window any of its original programs internationally, if it wishes them to remain exclusive.

Accessibility of Netflix

Apart from its original content offerings, the strongest aspect of Netflix's business model is its level of accessibility as a distribution platform. Reflecting the prioritisation of convenience by online audiences (Strangelove 2015, p.126), Netflix has benefited from positioning itself as a pre-loaded app on smart TVs, gaming consoles, and mobile devices (Lindsey 2016). While other VOD services now offer similar availability, Netflix's first mover status- in both this and original programming- has placed it at an advantage for adoption, especially in terms of younger audiences and 'cord-cutters'. In the post-legacy market, where television is increasingly seen as "merely another form of audio-visual content to be watched whenever and wherever users demand" (Bennet 2011, p.1), Netflix has so far succeeded by making itself ubiquitous and its content readily available. However, as competitors begin to co-opt this model, the lack of strong aggregated content available on the site by comparison could threaten its primacy³. In particular, network-supported apps such as Hulu and CBS All Access host content that is available on Netflix while also offering current primetime series and live sport/event programming such as National Football League games and award shows⁴; All Access will also begin streaming exclusive content live in 2017 (Lindsey 2016). Although there is a chance that if these companies also improve their original content, Netflix could lose those interested in catch-up viewing (Strangelove 2015), it is more likely that this will result in additional, rather than alternative, subscriptions for most users.

RECOVERY OF COSTS

Mirroring issues faced by multi-channel service operators in the 1980s, Netflix has begun to experience losses due to a lack of sufficient revenue to cover its increased expenses for production and acquisition of content (Vogel 2015).

Subscription Model

Netflix utilises a pure subscription model, relying on its monthly fee to generate revenue (Ulin 2014). However, despite increases in the number of subscribers, the company has seen a continual drop in its average revenue per paying user, from \$11.84 (Netflix 2012) to \$8.15 per month (Netflix 2016), reflecting the law of diminishing returns. While Netflix (2017b) has stated a need to grow content spending slower than revenue, the evolution of its business model toward original content, as well as its rapid international expansion, fail to reflect this. Currently, the company is funding its investments through a combination of operational profit and debt (Netflix 2017c), with \$6 billion in content commitments over the next five years, as well as an additional \$3-5 billion in obligations and \$3.3 billion in debt (Netflix 2016); while the company had previously expected to “generate material global profit” in 2017 (Netflix 2017b), it now estimates free cash flow to be -\$2 billion (Netflix 2017c).

Secondary Streams

Although the company benefits from its affordability- evidenced by a churn rate of 9% versus competitors Amazon Prime (19%) and Hulu (50%) (Parks Associates 2016)- its lack of significant secondary revenue streams is fast becoming its primary weakness.⁵

Windowing

As noted with regard to distribution, Netflix’s decision to expand internationally, in combination with its day-and-date release structure, has negatively impacted its ability to window content on a global scale, and thus amortise its production costs (Vogel 2015, p.234). While the company does obtain other secondary rights to DVD and download sales via its financing, these are less valuable for Netflix than they are for network distributors. While broadcast and cable series appear on streaming services for a certain period, they eventually disappear and consumer investment in a box set or digital copy becomes justifiable. However, in the case of Netflix, where original programs are hosted indefinitely in order to attract subscribers, there is little motivation to purchase a single series, either for catch-up or collection, nor any eventual avenue to syndicate content. Ultimately, while Netflix has provided an additional window for legacy television networks (Doyle 2016), it gains little benefit from the process itself.

PRODUCT PLACEMENT AND MERCHANDISING

In terms of product placement, a number of brands appear on Netflix’s original programs. Anheuser-Busch, whose beverages featured prominently in “House of Cards” third season, has confirmed sending stock to the production’s set designers (Steinberg 2015), while Chinese smartphone manufacturer OnePlus admitted to paying \$300,000 for its devices to appear on the show (Warren 2016); previous unofficial estimates placed

potential placement fees between \$50,000 and \$200,000 (Atkinson 2015). However, Netflix refuses to confirm these deals (Steinberg 2015), or identify revenue as such in its reports; the same policy is applied to merchandise.

Lack of Advertising

In discussing the possibility of advertising, Netflix has repeatedly refuted the suggestion, with Wells noting that it's counter to the company's brand (Powell 2016). While this position does limit potential revenue, it has also benefitted the company in terms of subscriber growth, with the presence of ads being one of the most common complaints among online viewers (Strangelove 2015, p.126); this is evidenced by Hulu's high churn rate. Where it remains most valuable, however, is in endearing Netflix to content creators. By not having to "manufacture plots with points of climax before prescribed commercial breaks", they're able to maintain a rhythm and aesthetic that lends itself to high quality programming (Lotz 2014, p.194). As "Arrested Development" star Will Arnett noted, by not having to worry about the ratings (traditionally tied to advertising):

"[Actors and writers] are encouraged to make a more interesting show as opposed to flattening it out...it's very inviting to people in the creative community to have a place like Netflix" (Roetggers 2013).

CONCLUSION

Overall, Netflix has a strong business model based on the production and distribution of premium original content. However, as the company moves forward, it faces the challenge of balancing acquisition and subscriber growth, otherwise it risks overextending itself financially. As the market evolves over the next several years, it will also need to remain aware of issues such as net neutrality and the emerging role of gatekeepers such as Apple, Amazon, and Google

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