THE BUSINESS OF MEDIA DISTRIBUTION, THIRD EDITION:
MONETIZING FILM, TV, AND VIDEO CONTENT IN AN ONLINE WORLD
BY JEFFREY C. ULIN

ONLINE SUPPLEMENTARY MATERIAL

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Significant portions of the e-Resources included in this supplementary material are reproduced
without modification from the 2nd and 1st editions of this book. To the extent that markets or
concepts have materially changed over time, I have strived to address those changes and the
current landscape in the current (3rd) edition. By reproducing sections without change my goal, in
part, is to document/maintain a snapshot of key industry fundamentals that were at the time
critical to the ecosystem. For example, the video market has dramatically changed over the last
ten years, from a segment that represented nearly half of all motion picture studio revenues and
sustained a vibrant retail business (both for renting and purchasing videocassettes and later
DVDs), to a revenue stream that is a fraction of its peak, continues to decline, and is being
replaced by VOD options; accordingly, I de-emphasized the discussion of the video market in the
3rd edition, but felt it is important to maintain access to an overview of the fundamentals of this
multi-billion dollar consumer retail market (including its roots, evolution, and economics).
Similarly, physical film prints are now an artifact, yet the economics of that pillar of the
distribution chain remain instructive, as is the evolution of D-cinema in general. Accordingly, I moved material sections here: from chronicling the videocassette market, D-Cinema growth, the demise and underpinnings of studio joint ventures, and the fundamentals of TV syndication (and barter) market, as well as describing the nature of calculating TV runs (free and pay), understanding Internet AVOD roots (e.g., Hulu’s prior incarnation), grasping market fears and factors of Online/VOD/Internet distribution, and delving into case studies of leaders that faltered in adapting to changing market conditions.

Please apply a filter and perspective to these supplementary materials, some of which still describe current elements but may have been moved given the nuanced detail (e.g., variations on structuring types of profit participations), while others capture a snapshot of elements that may have waned or in cases entirely disappeared. For markets/elements that may have disappeared, been restructured, or are experiencing an ongoing decline, there are still interesting lessons to be gleaned (management of a consumer product such as a DVD/videocassette on the retail shelf)—especially as parallel elements or models may develop downstream.

CHAPTER ONE: Market Opportunity and Segmentation – The Diverse Role of Studios and Networks

STUDIOS AS DEFINED BY RANGE OF PRODUCT — RANGE OF LABELS AND RELATIONSHIPS

[The following material is reproduced from the 2nd Edition eResources without modification]

Range of Relationships

In addition to subsidiary film divisions that specialize in certain genres or budget ranges or simply add volume, studios increase output via housekeeping deals with star producers and
directors. Studios will create what are referred to as “first look” deals where they pay the over-
head of certain companies (e.g., funding offices on the studio lot) in return for a first option on
financing and distributing a pitched property.

These deals take all forms, but the most common are puts and first look deals.

*Puts*

Under a put arrangement, a producer or director may have the ability to force the
studio to finance and distribute a project, as long as certain defined specifications have been
met. These deals are rare: no one wants the obligation to blindly make a film, no matter who is
involved.

Puts are, accordingly, usually limited to joint equity arrangements in which a
filmmaker with a preset deal can invest in a project and force the studio to co-invest and
release the property. Even in this scenario there will be very specific hurdles to trigger release
including budget

parameters, on-time delivery, ratings, approvals over attached elements, etc. Under the deal
the parties will have pre-agreed key economic terms, such as: (1) the studio’s commitment to
pay for defined tiers of prints and advertising/media to release the film, (2) distribution fees,
(3) recoupment of production and release costs, (4) ownership, and (5) relative splits of profits
from defined revenue streams.

*First Look Deals*

Much more common than puts are first look deals. Under a first look deal, the same
lit- any of economic terms are agreed up front, so that the only issue the parties face is literally
whether to make the film, rather than what are the terms between them if the film is made.
In many regards, a first look deal is the goal of every producer and director. What they gain is financing to develop story ideas with studios covering a fixed portion of their overhead, including in cases funding to hire writers. In essence, a first look deal pays the rent and allows directors, producers, and writer–producers the freedom to create. As they say: It’s a good job if you can get it.

What is required in return? In simple terms, a first look. In practice this means that when a producer is ready to present a project to its studio partner/banker, he formally submits and pitches the project. The studio then has a defined period of time to make up its mind whether or not to accept the project. What needs to be submitted for the project is deal specific, but the following items are often required:

- A finished script
- Suggested, or ideally attached, talent (a director and/or actors)
- Visual development materials
- Budget parameters, including costs to date and any other economic items that would significantly influence the viability of the project (people are obviously cagey about budgets and costs at this early stage)

Accepting the project has two consequences. First, it means that the producer cannot present or even talk about the project to another party. Basically, it grants the studio an exclusive, and with the exclusive absolute confidentiality of the project if it so chooses. Oddly, as with many quirks of the media business, while confidentiality may be the better business decision, studios and networks will frequently announce the acquisition of the project. Whether this serves as mere bragging rights, or a conscious declaration to competitors that an exclusive has been sewn up, is in the eye of the beholder.

The second consequence to accepting the project is that the studio triggers some of the
pre-agreed economic terms. There may be a payment triggered to option the property, or a larger payment to outright acquire it. More important, the decision to accept the property cues it up in the production pipeline as a commitment is made to further ready the property for production. The property enters a nebulous area between script development and pre-production and the parties then have a period to set the remaining elements. This could include:

- More drafts of the script to get to a shooting script
- Signing key talent including actors, a director, and line producer
- New or additional visual development
- Delivery of budgets
- Commitment of financing if there are other parties involved

All of these items cost money with some costing millions of dollars. Accordingly, the decision to accept the project, which is still not guaranteed to be made at this stage, is not a trivial election. The idea that one would not sink this additional money into a project (remember, the studio has likely sunk hundreds of thousands of dollars, if not millions of dollars, to develop the property up to this juncture) if they did not want to produce it is true; however, no project in the development pipeline is ever guaranteed to be made and Hollywood is filled with more projects that almost got made than projects that the public has seen. Many pieces have to come together before the magic greenlight, and even then a plug can be pulled.

In the end, when the studio accepts the project it controls its destiny and takes it off the market — all things it wants, but all things for which it will pay dearly. For the producer (and I will continue to use the term producer liberally here, for it could be a director or writer), it means he is one step closer to the goal of filming the project and transforming an idea into a movie or TV show; additionally, it means more funding can be secured.
All of this supposes that the studio likes the submission: But what happens if they are on the fence? Despite the studio sitting in the enviable seat as a buyer with lots of properties from which to choose, the decision is a difficult one and different from many other supply chain situations where purchasers tender a request-for-proposal and review the pros and cons of suppliers’ bids. There are similarities in that issues of reliability, quality, relationship, and cost will all be taken into account. However, because of the first look relationship on which the decision is premised, many of these issues are already set and the decision comes down to two fundamental questions: how much do I subjectively like the project, and what are the chances that if I pass on it my competitor will produce it and make me look like a fool?

The second question is made more difficult because you are likely dealing with someone either famous, or if not outright famous than likely highly regarded and well connected; if that were not the case, there would be no first look relationship to begin with. The threat of taking a project across the street to a bitter rival and having the ability to actually produce it with them is very real. Hollywood is littered with the lore of so-and-so passed on that project or he had the courage/vision to get behind X. Careers are literally made and broken on these decisions. Despite all of these complications and tough decisions, first look deals are still a staple of Hollywood because studios want to make movies and they want first access to the people they want to make them with. Paying for what amounts to a type of option on an exclusive has therefore evolved as a hedged economic alternative. As the business has matured, and individuals have gained more clout, it could now be prohibitively expensive to keep individuals on the payroll. Gone are the Studio System days when stars literally worked for the studios and were contracted to make a certain number of pictures.
Accordingly, first look deals have evolved as a middle ground. For a price studios secure access to ideas and talent, but gain flexibility by not actually committing to make any picture or a specific number of pictures with an individual. Producers/talent have someone else pay for what they want to do anyway (without a first look deal they would still be developing properties, but on their own nickel), and maintain the freedom that if the studio is not keen on the project they can take it across the street to a competitor because the first look deal creates no barrier to getting the project made. From an economic standpoint, a first look deal is the ultimate hedging of bets on both sides.

RANGE OF ACTIVITIES—DISTRIBUTION ENCOMPASSES MANY MARKETS

Format Variations

The following Figure 1.4 depicts what is arguably the peak of format variances, and assumes a film that is:

- initially released in theaters, in at least 35 markets around the world
- released worldwide in the home-video market on DVD and VHS, and that consumers are offered a range of formats, such as a letterbox version (a “widescreen” version that leaves black on the top and bottom of the screen) and a “pan-and-scan” version that is reformatted from the theatrical aspect ratio to fill up a traditional square television screen (note: VHS releases and pan and-scan are largely phased out, but the analogy remains, as for example, there will be Blu-ray and traditional DVD SKUs)
- released into major pay TV markets worldwide (channels may have different specs)
Historical Joint Ventures

Studio joint ventures grew in the 1980s with the globalization of the business. The number of titles a studio released fell within a relatively static range, and even a significant percentage increase in product still meant a finite number of major films (e.g., 20 or 30). What changed dramatically was the importance of the international markets. In the early 1980s, the international box office as a percentage of the worldwide box office was in the 40 percent range, then grew to over a 50 percent share by the mid-1990s, by the mid-2000s had grown to more than 60 percent,¹ and by 2010 started to approach 70 percent (e.g., 68 percent in 2011; see Figure 1.7 and also Table 4.1 in Chapter 4). (Note: In 2010, foreign sales accounted for roughly 70

¹

Figure 1.4 Volume and complexity of Release Versions]
percent of total receipts, both for industry and for the movie *Avatar*.)

**Demise of Historical Joint Ventures**

When individual territories outside the United States started to represent the potential, and then the actual, return of tens of millions of dollars, the studios needed to build an infrastructure to manage and maximize the release of their products abroad. Moreover, this matured market by market. First, the growth of the international theatrical market warranted the expansion. Shortly thereafter, with the explosive growth of the videocassette market in the 1980s and 1990s, including the 1990s expansion of major United States retailers such as Blockbuster to international markets, studios needed to mirror theatrical expansion on the video side. Distribution of videocassettes (now DVDs and Blu-rays) and of movies into theaters utilizes the same underlying product and target consumers, but the similarities stop there; the differences of marketing a live event in theaters versus manufacturing a consumer product required different manufacturing, delivery, and marketing, and with it a different management infrastructure.

Three studios joined together to form United International Pictures, better known in the industry by its abbreviation UIP. Headquarteredin London, UIP was historically a joint venture among Paramount Pictures, Universal Pictures, and MGM (MGM later dropped out, but the volume of titles remained high as DreamWorks titles were put through the venture). The three parties shared common overhead in the categories described above: general management, finance, marketing, sales, and legal. Additional efficiencies were gained by sharing office space and general sales and administrative budget cost lines.

What was not shared is perhaps more interesting—the parties shared costs, but did not share revenues. A cost-sharing joint venture is a peculiar instrument of fierce competitors in the film
community. Natural adversaries came together for two common goals: protection of intellectual property and the need to establish sales and marketing beachheads around the globe for as little overhead as possible. Both goals could be completely fulfilled without sharing revenues on a per-product or aggregate basis; perhaps more importantly, the structure of the business likely would not have permitted the sharing of revenues even if this was a common goal. Because each film has many other parties tied to it, with complicated equity, rights, and financial participation structures, it is unlikely that all the parties who would need to approve the sharing of such revenues would ultimately agree to do so.

Why, for example, would Steven Spielberg and Universal all agree to share revenues on its film *Jurassic Park* with Paramount or MGM? Similarly, why would Paramount Pictures and Tom Cruise want to share revenues on *Mission: Impossible* with Universal? The simple answer is they would not, and they do not. Every one of these parties, however, has a vested interest in the films released under a structure that: (1) minimizes costs and therefore returns the greatest cash flow; (2) protects the underlying intellectual property and minimizes forces such as piracy that undermine the ability to sell the property and generate cash; and (3) maximizes the sales opportunities.

Once this formula is established, it is relatively easy to replicate for other distribution channels. UIP, for example, spun off a separate division for pay TV (UIP Pay TV), a market that exploded in the early 1990s. The same theatrical partners joined forces to lower overhead and distribute product into established and emerging pay TV markets worldwide.

Additionally, two of these partners, Paramount and Universal, teamed up for videocassette distribution and formed CIC Video (where I once worked, based in UIP House in London). CIC, similar to UIP and UIP Pay TV, set up branch operations throughout the world headquartered in
the UK. Table 1.1 is a representative chart of countries served by direct subsidiary offices.

**2nd Edition Table 1.1 Countries Served by Direct Subsidiary Offices/Territory**

<table>
<thead>
<tr>
<th>Country</th>
<th>Country</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>Malaysia</td>
</tr>
<tr>
<td>Brazil</td>
<td>Mexico</td>
</tr>
<tr>
<td>Denmark</td>
<td>New Zealand</td>
</tr>
<tr>
<td>France</td>
<td>Norway</td>
</tr>
<tr>
<td>Germany</td>
<td>South Africa</td>
</tr>
<tr>
<td>Holland/The Netherlands</td>
<td>South Korea</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>Spain</td>
</tr>
<tr>
<td>Italy</td>
<td>Sweden</td>
</tr>
<tr>
<td>Japan</td>
<td>United Kingdom</td>
</tr>
</tbody>
</table>

In addition to direct offices, the venture would service licensees in countless other territories. These are examples of territories, which at least historically/initially, were typically managed by studios as licensee markets: Argentina, Chile, Colombia, Czech Republic, Ecuador, Finland, Greece, Hungary, Iceland, Indonesia, Israel, Philippines, Poland, Portugal, Singapore, Taiwan, Thailand, Turkey, Uruguay, and Venezuela. (Note: This is not an exhaustive list.) Whether it makes sense to operate a subsidiary office or even to license product into a territory at all depends on factors including market maturity, economic conditions, size of the market, and the status of piracy/intellectual property enforcement. Many of the largest developing markets, which historically have been licensee territories throughout most of the span of the era of joint ventures, including Russia, China, and India, have been transitioned by studios into direct
operations. Russia serves as a prime example, as rapid economic growth propelled the theatrical market from insignificant to among the top 10 worldwide markets in just a few years.

UIP and CIC, although among the longest lasting and most prominent joint ventures (UIP was formed in 1981), are simply examples, and many other companies similarly joined forces in distribution (e.g., CBS and Fox formed CBS/FOX Video, partnering to distribute product on videocassette worldwide).

*Demise of Historic Joint Ventures*

None of UIP, CIC, UIP Pay TV, or CBS/FOX Video exists today in their grand joint-venture forms. First, UIP Pay TV was disbanded in the mid 1990s, then the video venture CIC was largely shuttered by 2000, and finally UIP’s theatrical breakup/reorganization was announced in 2005 and implemented in 2006 (though the partners still distribute via the venture in limited territories). Why did this happen?

The answer is rooted partly in economics and partly in ego. The economic justification in several instances was less compelling than when the ventures were convenient cost-sharing vehicles enabling market entry and boosting clout with product supply. In the case of pay TV, for example, the overhead necessary to run an organization was nominal when compared to a theatrical or video division. Most countries only had one or two major pay TV broadcasters; accordingly, the client base worldwide was well under 50, and the number of significant clients was under 20.

This lower overhead base, coupled with growing pay TV revenues, made the decision relatively easy. Additionally, given the limited stations/competition and the desire to own part of
the broadcasting base, the studios started opportunistically launching joint or wholly owned local pay TV networks. Over time, services such as Showtime in Australia or LAP TV in Latin America, both of which are owned by a consortium of studios, became a common business model. Fox was among the most aggressive studios, replicating its successful Sky model in the UK and owning or acquiring significant equity stakes in the largest number of pay TV services worldwide. The Fox family of global pay networks grew to include the following major services:

- BSkyB—UK
- Star—Asia (including Southeast Asia, India, Mideast, China/Hong Kong)
- Sky Italia—Italy
- LAP TV (partner interest in Latin American service)
- Showtime—Australia (partner in PMP, pre-Foxtel interest)

The logic behind the breakups of CIC and UIP are a bit more complicated, and are seemingly grounded as much in politics as economics. In both instances, the companies called on thousands of clients, and the range of titles from multiple studios virtually ensured the entity of some of the strongest and most consistent product flow in the industry—a fact that is critical in a week in, week out business. A video retailer is more likely to accept better terms and take more units from one of its best suppliers, knowing that a blockbuster it is likely to want will always be just around the corner. This strength of product flow, however, also turned out to be a problem with local competition authorities.

UIP was forced to defend anticompetitive practices allegations for years, and formally opposed an investigation by the European Union Commission (Competition Authority) in
Brussels that threatened sanctions and even the breakup of the venture. Some argue that the EU Commission’s claims were politically bolstered by member states with protectionist legislation and quotas for locally produced product. In the end, UIP was successful in its defense, but the company was always a political target and forced to be on guard.

In addition to theoretical arguments regarding anticompetitive behavior given market leverage, these types of joint ventures were always in the spotlight for specific claims. One of the most active watchdogs has been the competition authority in Spain. In 2006, the studios were fined by the Spanish authorities on a theatrical claim. Variety reported: “In the biggest face-off in recent years between Hollywood and Spanish institutions, Spain’s antitrust authorities have slammed a €12 million ($15.3 million) fine on the sub-branches of Hollywood’s major studios in Spain for cartel price fixing and anticompetitive coordination of other commercial policies.”

Cases such as this only make operators of a joint venture among studios all the more paranoid.

Competition concerns aside, these ventures always had the maverick studio boss looming over them, wary that his or her film was somehow disadvantaged by treatment of a competitive partner’s title. The defense to this type of attack is that there will always be a competitive film, and better it be in the family so the headquarters can work to maximize all product; at least in a venture it is theoretically easier to schedule releases and allocate resources so that one studio’s product is not directly against another partner’s product (although, in practice, pursuant to antitrust/competition rules studios cannot share release dates). Ultimately, no matter what argument is made, the concern comes down to focus: every studio wants its big title pushed at the expense of everything else, and this is hard (at least by perception) to achieve in a joint venture. As the markets matured, and the international theatrical and video markets continued to grow as a percentage of worldwide revenues, many studio heads wanted unfettered control and
Many have argued that the breakup of these ventures simply for dedication and control is economic folly. These joint ventures had been releasing major studio hits for decades without discriminating one over the other. In fact, they could not discriminate, for the partners were always wary of this, and any significant diverting of focus or resources to one partner versus another would not be tolerated. Moreover, focus/dedication would have to yield a return that recovered 100 percent of the overhead now borne by the studio that had been allocated to its partner(s) previously. In a 50/50 joint venture, that means recouping an equivalent of 100 percent more than it needed to previously (e.g., if $20 million in total overhead, the studio now needed to recoup the full $20 million rather than only $10 million), and in a partnership with three parties it was even worse. These are pure bottom-line sums, for direct picture costs were already allocated by title. It is for this reason that politics comes into the equation. Clearly not all product will have an uplift to cover the additional overhead costs, but by the same measure never again will an executive of Studio X be fearful that he or she left money on the table for a major release because resources were diverted to a competitor’s film.

Sample Breakdown Across Labels from the Heyday of Specialty Labels (e.g. FOX)

<table>
<thead>
<tr>
<th>Label/Releasing Arm</th>
<th>Division B.O.</th>
<th>% of Total Studio B.O.</th>
</tr>
</thead>
<tbody>
<tr>
<td>20th Century Fox</td>
<td>$1.1 billion</td>
<td>72</td>
</tr>
<tr>
<td>Fox 2000</td>
<td>$272 million</td>
<td>17</td>
</tr>
<tr>
<td>Fox Searchlight</td>
<td>$162 million</td>
<td>10</td>
</tr>
</tbody>
</table>
## Channels: Expanded Demographics/Specialties

### 2nd Edition Table 1.10 TV Channel Demographics/Specialities

<table>
<thead>
<tr>
<th>Demographic/Specialty</th>
<th>Channel</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Kids</strong></td>
<td>Nickelodeon</td>
</tr>
<tr>
<td></td>
<td>Noggin</td>
</tr>
<tr>
<td></td>
<td>Cartoon Network</td>
</tr>
<tr>
<td></td>
<td>Disney Channel</td>
</tr>
<tr>
<td></td>
<td>ABC Family</td>
</tr>
<tr>
<td></td>
<td>PBS Kids Sprout</td>
</tr>
<tr>
<td><strong>General sports</strong></td>
<td>ESPN, ESPN2</td>
</tr>
<tr>
<td></td>
<td>Comcast Sports Net</td>
</tr>
<tr>
<td></td>
<td>Fox Sports Net</td>
</tr>
<tr>
<td><strong>Golf</strong></td>
<td>Golf Channel</td>
</tr>
<tr>
<td><strong>Weather</strong></td>
<td>Weather Channel</td>
</tr>
<tr>
<td><strong>Women</strong></td>
<td>Lifetime</td>
</tr>
<tr>
<td></td>
<td>Oxygen</td>
</tr>
<tr>
<td><strong>Animals and nature; world</strong></td>
<td>Animal Planet</td>
</tr>
<tr>
<td><strong>wildlife and culture</strong></td>
<td>Discovery Channel</td>
</tr>
<tr>
<td></td>
<td>National Geographic Channel</td>
</tr>
<tr>
<td><strong>News and finance</strong></td>
<td>CNN</td>
</tr>
<tr>
<td>Category</td>
<td>Channel Name</td>
</tr>
<tr>
<td>---------------------</td>
<td>-------------------------------</td>
</tr>
<tr>
<td>CNN FN</td>
<td></td>
</tr>
<tr>
<td>MSNBC</td>
<td></td>
</tr>
<tr>
<td>Fox News Channel</td>
<td></td>
</tr>
<tr>
<td>Shopping</td>
<td>Home Shopping Network</td>
</tr>
<tr>
<td></td>
<td>(HSN)</td>
</tr>
<tr>
<td>Food</td>
<td>Food Network</td>
</tr>
<tr>
<td>Travel</td>
<td>Travel Channel</td>
</tr>
<tr>
<td>Comedy</td>
<td>Comedy Central</td>
</tr>
<tr>
<td>Independent film/classics</td>
<td>Sundance Channel</td>
</tr>
<tr>
<td></td>
<td>IFC</td>
</tr>
<tr>
<td></td>
<td>AMC</td>
</tr>
<tr>
<td>Science fiction</td>
<td>Syfy Channel</td>
</tr>
<tr>
<td>Music related</td>
<td>MTV</td>
</tr>
<tr>
<td></td>
<td>VH1</td>
</tr>
<tr>
<td>History</td>
<td>History Channel</td>
</tr>
</tbody>
</table>
CHAPTER TWO: INTELLECTUAL PROPERTY ASSETS ENABLING DISTRIBUTION—The Business of Creating, Marketing and Protecting an Idea

[The following materials are reproduced from the 1st and 2nd Editions without modification]

THE DEVELOPMENT PROCESS — DEVELOPMENT GUIDELINES

The following could be perceived as written from the perspective of someone pitching a project faced with the challenge of how to sell an idea. Whether or not a business or creative executive, serving as the gatekeeper, actually addresses these issues as well (or is even concerned about them), this section illustrates the types of practical and political concerns those executives may need to address beyond the intangible of the creative itself. In essence, everyone is selling: the creative executive who likes a project still needs to champion it within his organization, and is likely to address several of these issues whether or not he believes they are salient.

Is the Idea Sustainable, or —Big Enough?

Many ideas are the equivalent of one liners or gags without enough depth to sustain 90 minutes of action, emotional development, and story arc. Frequently, ideas that truly are limited may move forward in the development process under the assumption that a good writer can add enough spice to make it work. I am sure everyone has come out of at least one movie thinking why was that made, or the only funny thing was in the trailer; while there are lots of reasons this can occur, a fundamental one is an error made at this early juncture.

Is the Idea Original?

Several questions are invoked by the term original. First, is the idea stolen or too close to another idea to be a violation of a third party’s copyright? Second, will others view it as original, or will it suffer by an easy comparison (—oh, that’s just like X, but with Y). Third, is
there a competitor making or developing something similar? Oddly, Hollywood tends to be a
business where the answer to this last question may not matter. There are numerous cases of
studios rushing projects forward to beat a competitor to market on a similar theme. Disney/
Pixar made A Bugs Life at the same time DreamWorks/PDI was making Antz. Similarly in
2000 Disney and Warner Bros. both released movies about missions to Mars (Mission to Mars
in March and Red Planet in November, respectively, starring Gary Sinise and Val Kilmer). In
1998 DreamWorks and Disney each released films about a meteor hitting earth and threatening
the end of the world (Deep Impact in May and Armageddon in July, respectively, starring Tea
Leoni/Robert Duvall/Morgan Freeman and Bruce Willis/Ben Affleck). Having started this
para- graph asking –is the idea original I will end it by asking –does it matter?

Is the Idea Inherently Expensive or Modest to Produce?

Budgets play a role even at this early stage. Although it is true that quality
compromises may not necessarily jeopardize results, there will be an understanding of budget
parameters at concept stage. Jurassic Park would not have been successful with cheesy
dinosaurs and back- yard settings.

Does the Story Lend Itself to the Medium Contemplated?

If an idea involving three kids and household sets is pitched as an animated project, a
natural question would be why not make it live action? There may be a perfectly good
answer, but not all ideas translate easily into all formats and genres. A key goal at this early
stage is to eliminate obstacles and create potential, not burden a project with hurdles.

Does the Concept Have Franchise or Merchandising Potential?
Some movies and stories are naturally one-offs, while others have inherent potential to spawn far reaching franchises and licensed products. Depending on the medium involved, it may be important whether or not the property easily lends itself to merchandising, sequels, etc.

A Woody Allen movie is a completely different product than a kids’ property hoping to tie in a toy line.

Does the Idea Have General Appeal, or is it Geared Toward a Targeted Market?

If you are developing an idea to pitch to MTV Films, it is clear you are trying to create a certain edge; on the flip side, if you are trying to customize pitches for the MTV demographic, you may need to acknowledge that you have a limited universe to pitch the idea to and if it does not work with one or two key players it is likely never to get off the ground.

No matter how great an idea, a project will inevitably be put through the meat grinder of the previous questions. Projects that are crafted to satisfy all of these business issues are often compromised or watered down, and it is the challenge of development to strike a balance between creativity and marketability. Everyone is looking for brilliance rather than a least-common denominator, and yet navigating the gauntlet of development and marketing questions is critical when fostering the best ideas and allowing them to surface amid brutal filtering grounded in personal and subjective judgments.

Market Timing

Despite the fact that development and production lead times are often so long that it would be impossible to predict what will be “hot” when it is ready for market, nearly everyone tries. These are some of the questions frequently posed in the hopes of achieving perfect timing.

Is There a Well-known Source upon which the Movie is Based?
As previously discussed, producers are always looking for ideas with built-in awareness such as books or mass market news events. A perfect example would be *The Da Vinci Code*, a high-profile movie from Imagine, directed by Ron Howard and starring Tom Hanks, based on Dan Brown’s novel, which was a phenomenon lingering atop the *New York Times* bestseller list for years. With the book still immensely popular, the movie launched the 2006 summer holiday season in May (opening May 19, 2006, the weekend before Memorial Day weekend, which has become among the most if not the most coveted release date of the year).

*Is There a Hot Genre?*

The success of a film can cause a source to be perceived as hot; for example, comic books blow hot and cold. For years there may not be much interest, and then the success of a movie like *Spiderman* may send people screaming for every Green Hornet gem they can un-earth.

This factor may be more apt for TV, since the medium has shorter lead times and can adapt more quickly. The improbable primetime success of the game show *Who Wants to Be a Millionaire* fueled a craze to find other game show properties, and soon shows like *The Weakest Link* became primetime competition; the trend of low-cost primetime game shows continued with *Deal or No Deal* and *Are You Smarter than a 5th Grader* making the ratings cut.

Perhaps a more dramatic example was the explosion of reality-based TV shows following the success of *Big Brother* and *Survivor*.

In 2000 there were no –pure reality shows in primetime on the four big networks, but from 2003–2005 the genre exploded. Examples of reality shows during this period included *Survivor, The Bachelor, The Bachelorette, Meet the Parents, The Simple Life, Nanny 911, The
Apprentice, Home Makeover, Big Brother, and Queer Eye for the Straight Guy. The trend spun off into talent competitions such as Dancing With the Stars; the talent competition champion American Idol even catapulted to the top of the Fox network despite the underlying concept being close to the old Star Search. (It is unclear whether the phenomenon is driven by the interactive ability of viewers to participate via text messaging or whether the audience prefers caustic judges who may embarrass contestants rather than avuncular hosts; compare the blunt and charismatic Simon Cowell sparring with his co-judges to Ed McMahon, the former sidekick to Tonight Show host Johnny Carson). The success of the show led to copycat shows such as America’s Top Model, On the Lot, and America’s Got Talent. (Note: Many attribute the growth of reality shows to a time when networks needed to fill the airtime with non-scripted fare during the writer’s strike. When the results proved comparable in ratings and less expensive to produce, there was no turning back (which trend could threaten to make NBC’s recent elimination of its third hour of primetime (see Chapter 6) in favor of a hosted talk show (by Jay Leno) permanent.)

Is There a Hot Demographic?

As trends ebb and flow, an urgency will be created to hit a certain market. Often, this mirrors a trend to label a demographic as a new entity, as if people in the age group had never been there before: Tweens, Gen X, Gen Y.

Is There an Emerging New Platform or Delivery System? (Sometimes it is Possible for the Tail to Wag the Dog)

The emergence of DVD did not cause people to produce TV or film with an eye toward ancillary DVD sales (at least initially), but as the market grew the revenues from the video and
DVD market filtered into the decision-making process — a property that was perceived as
strong title for the direct-to-consumer video market could be perceived differently.

OPTIONING PROPERTIES — THE OPTION CONTRACT

A typical film or TV option contract has these deal elements impacting financial value:

□ Exclusivity — Options are by their nature exclusive.
□ Cash Consideration — A specified sum is paid for each defined option period.
□ Option Extensions — Because development and writing can take a long time, and
time periods are often dependent on availability of specific individuals, options
usually have one or two built-in extension periods, each of which requires
additional payments.
□ Term — Options are usually for periods of several months or more, and often
se- cured in six-month or yearly increments (e.g., 1 year, 18 months).
□ Reversion of rights on failure to exercise option.
□ Purchase Price — The option holder may -exercise the option‖ by giving notice
within the option period and paying the agreed purchase price.
□ Contingent Compensation — An agreed sharing of downstream revenues, where
the owner may receive a share of profits (see Chapter 10), thus preserving an upside
in addition to the up-front purchase price received.
□ Rights — The option agreement carefully defines what rights are transferred
and what rights, if any, are reserved for the owner.

Once all the nuances are negotiated, and legal definitions, representations and
warranties, approval rights, credits, etc., are added, this simple skeleton will balloon into a
lengthy document. Options are more complicated than they may seem at first, for while the
agreement may strike a middle ground by deferring the lion’s share of the money until a later date (e.g., the purchase price), the agreement needs to pre-define what happens if the option is exercised. This means that the agreement will usually define services (if the creator is to play any role in development or production) and detailed compensation triggers expressed in bonuses or shares of profits.

Because of the nature of intellectual property, rights are infinitely divisible, and it is possible to tie participations to different revenue streams and create different definitions and triggers within each category. Someone may participate in video revenues or merchandising revenues, but not musicals, and the calculation of video revenues and profits may vary dramatically from merchandising. In theory, the permutations are endless. (See Chapter 10 for a de-tailed discussion of contingent compensation.) In practice, the permutations are the guts of the business because they relate to distribution channels and risk taking.

COMPENSATING WRITERS — INDEXING VALUE TO DEVELOPMENT VERSUS DISTRIBUTION RESULTS

The following is a bit of a digression, but in terms of understanding both the P&L of a project (profits, as discussed in Chapter 10), the dynamics of union negotiation stalemates over the treatment of new media residuals and payments (as discussed in Chapter 7), and the inter-play of production versus distribution costs, it is important to grasp how creative talent is paid. There are similarities in compensating all -above-the-line talent (e.g., writer, director, producer, principal cast), but I focus on writers here because not only do they bridge development and production but they also provide a good example of indexing tiers of compensation from development through distribution exploitation.
Writers as the Catalyst for any Project — the Unsung Heroes

Every good producer and director will advise that a successful property is all about the story (which underlies why optioning properties is so competitive). If the story and script are not solid, the project is at worst doomed and at best unable to fulfill its full commercial potential. To create a film or television show is a bit like starting a business from scratch, and the executive producer needs to build the infrastructure and assemble the main players, specialists, and advisors. The very first step is engaging a writer. A project thus starts with just a handful of people, then grows to involve hundreds or thousands (before it is complete), and eventually winds back down to a few people again. It is the earliest phase that concerns writers, and although it is hard to draw exact lines, development is the stage from concept inception through crafting a script that is ready to be produced.

Not only is hiring a writer the first step in development, it is also the most important. The production company or producer developing an idea or property has a loose framework for the project (e.g., treatment), but needs to translate that story, outline, or concept into a workable script. To affect that transition the producer needs to source a writer with the right style or sensibility for the story, educate them about the idea, and grant them an element of freedom to express his vision for taking it forward. In essence, the producer comes to the writer with a blueprint — whether a short treatment, a prior book, visuals, or a combination of such elements — and together they set a game plan for the script.

Everyone is trying to get it right, but according to multiple Academy Award winning screenwriter William Goldman’s (credits include Butch Cassidy and the Sundance Kid, All the President’s Men, Marathon Man) — nobody knows anything mantra, — Not one person in the entire motion picture field knows for a certainty what’s going to work. Every time out it’s a
guess — and if you’re lucky, an educated one.

Such cynicism fails to halt the rush of scripts created daily, but it does underscore the often misunderstood value of scripts. In Hollywood and to executive producers, writers are valued and are the behind-the-scenes heroes that breathe life into projects and are responsible for getting them made. The disconnect, often lamented by writers, is that viewers tend to come away from TV shows or films knowing the actors, and in some cases the directors and even the producers, but rarely the writer. In a medium that is visual by nature, writers are basically unknown to the end consumer and often feel they get short shrift in the cult of Hollywood celebrity. How then do you compensate someone who feels unappreciated by the consumer, performs the most critical work to move an idea from concept to executable, and toils under the weight of—nobody knows anything?

**Economics of Hiring Writers**

The economics of a writer’s agreement are relatively straightforward. Because the endeavor is subjective — a script could be hailed by one person and derided by another — the writer is compensated for his time and the deliverable. There is little to no objective criteria for evaluating the quality of the deliverable; therefore, it is the act of writing (for an exclusive period) and delivering the script that is being contracted.

Quality comes into play in the form of reputation and end result — writers only obtain more work based on the reputation they build, which is gained both by word of mouth from others in the creative community as well as the objective standard of whether their scripts are produced. To the extent that the movie made becomes a hit, and the writer is accorded credit, the writer’s market value and star rises further. A natural hierarchy arises from how many
credits a writer has, does the writer have a track record of creating successes, and has the writer achieved both critical and commercial acclaim. A writer who has a track record of having their scripts made may not be a household name, but they are likely multimillionaires and stars in the film creative community.

As writers become successful the one element they have to offer beyond their creative ability is their time. Accordingly, compensation is guaranteed to secure an exclusive time commitment and deliverable, for compensation cannot be indexed on whether or not the producer likes the script; the up-front compensation will be indexed on how other producers liked the writer’s prior script and what they were willing to pay for the deliverable.

While it may be impossible to compensate a writer based on the quality of the script, this limitation only holds true for up-front guaranteed compensation for the deliverable. It is entirely feasible, and in fact customary, to pay writers bonuses based on success. Success can be tied either to having a film produced, the commercial success of the end product, or both. Most writer’s deals therefore tend to break compensation into three tiers: guaranteed compensation (dollars for services, not unlike any other service industry), bonus compensation (tied to milestones, again not unlike other service industries), and profit participations in the revenue stream of the finished film (somewhat unique to the industry, as discussed in detail in Chapter 10). Each of these is discussed briefly in the next section.

A final element influencing the economics of structuring writer’s deals is the Writer’s Guild of America (WGA). Unless someone is already an established and star writer, the leverage rests with the party paying the salary, which historically was the studio. The WGA is a union that has entered into a collective bargaining agreement with most key clients; namely the studios, networks, and key independent producers. It is through the leverage of this agreement
that writers are able to secure residuals, minimum tiered compensation for writing services, and an independent rules-based system for determining whether they are entitled to credit based on their work. The guild agreement provides key protections to writers, ensuring attribution (including guarantees regarding where and how credits are placed) and compensation thresholds that they would likely not be able to achieve without this framework.

**Guaranteed Compensation**

Scripts are written in stages, most often an initial draft plus a contracted number of revisions (i.e., rewrites and polish). Writers are contractually bound to deliver each set of drafts within a defined period of time (writing periods), and the producer likewise has a fixed period to read the draft and provide comments (reading periods). As previously noted, the commodity is time and the deliverable is the script.

Although actor and director compensation will not be similarly discussed, the same underlying premise applies in both of those contexts. Fixed fees will be paid based on time and deliverables, with time in the case of actors calculated based on minimum employment period (defined in guaranteed weeks, plus – free weeks before overages kick in) and deliverables being the performance rendered, and for directors time is usually bifurcated into exclusive and non-exclusive periods (exclusive from just before filming through the completion of photography) and the deliverable is the film/cut required.

**Bonus Compensation**

Writers typically receive two types of bonuses: a cash bonus and a percentage of the net profits. Both types of bonuses are contingent on the picture getting made, and the amount of the bonus is contingent upon the type of credit the writer receives. The WGA will determine final screenplay credit and accord either sole or shared credit. Bonuses are then indexed to
credit ac-corded with sole credit vesting 100% and shared credit a lesser sum, usually 50%. (Note, it is uncommon yet theoretically possible for more than two writers—with a team of writers being considered a single writer—to receive shared credit, making the calculation of potential bonus compensation complex and uncertain for the financing party.) With respect to the fixed sum or cash bonus, the bonus reflects that the writer’s work was good enough to get the picture made—an objective standard and a pivotal milestone. Accordingly, bonuses are carrots and can be quite large, even in cases reaching 100% of the initial fixed compensation.

**Contingent Compensation**

A grant of contingent compensation (i.e., a percentage of profits in the picture) acknowledges the writer as one of the most valuable creative individuals involved in the project. A customary grant would be tied to a specific corridor of profits, such as 5% of 100% of the net profits of the picture for sole screenplay credit, and 2.5% of 100% of net profits for shared screenplay credit (the reduction for shared is similar in concept and structure to the cash bonus). A writer of certain stature may be able to achieve an improved profit definition. (See Chapter 10 for a detailed discussion of defining and calculating net profits.)

**Royalties and Residuals; Sequels, Remakes, Television Series, etc.**

To ensure that the writer shares in the success of derivative productions based on the film for which he wrote the screenplay, writer’s agreements often provide for minimum passive payments. These payments are due if the writer is not engaged for writing services on such subsequent productions, but invariably require that the writer has been accorded screenplay credit on the initial picture (in some cases insisting on sole credit, under the theory that for a passive payment to kick in the writer must be the one that is truly responsible for the
screenplay and not simply a contributor). Passive payments vary, but are usually based on a
fraction of the fixed and cash bonus compensation paid for the initial picture. Finally, writers
are also paid residuals (a form of royalty) when the property is played and re-run or exploited
in ancillary markets with the amount ratcheting down over time.

I go into this detail for two reasons. First, it is instructive to see (1) how initial
compensation is linked to renting someone’s time and obtaining a deliverable (a script,
performance, or delivery of a finished film respectively, for a writer, actor, and director), all
sunk costs prior to exploitation, and (2) how bonus and especially contingent payments are
separately linked to the results of distribution (securing a distributor willing to invest to market
and release the film, and how much money is earned). Second, in the context of online
compensation, residuals, strikes, etc., it is easy to forget that there is already an elaborate,
layered compensation system taking into account up-front work (time) and paying bonuses and
contingent compensation tied to downstream success.

MARKETING IDEAS (AKA PITCHING) —
STRATEGY OF SETTING UP AND PREPARING FOR THE
PITCH (Note: The following applies primarily to film.)

The One Liner

Executives hearing pitches have limited time and there are infinite ideas: How do you
hook their attention so they want to hear more about a specific concept? It is no different than
individuals marketing themselves to a busy headhunter they get on the line, or a broker cold
calling a potential customer. Find a concise one or two liner to grab attention. How would
you describe *Star Wars, Lawrence of Arabia, James Bond*, or *Bull Durham* in one or two
compelling lines?
Story and Selling Keys

There are books and experts on story and creative writing, and it is not the intention here to give a tutorial on how to become a writer or craft the perfect story. That said, the marketing of a film idea follows certain patterns, and without an understanding of the rhythm and market nuances marketing attempts are an uphill battle (possibly making what is already an uphill battle a doomed endeavor). Securing a meeting with someone willing to take a pitch is a very difficult task; securing a meeting with the right person and someone who has authority to make a yes/no decision (i.e., the gatekeeper) is even harder. When set to pitch a project it is a business essential to be prepared, polished, and ready to address a range of likely questions.

These are questions and objectives that should be addressed up front, or with a ready answer waiting, before a pitch is made.

- What is the story about? In a couple of sentences, can you tell whose story it is and what happens?
- Make me care. What is the lead character’s goal or quest?
- What is the core conflict? Who is the villain, or who or what opposes the protagonist?
- What changes? How has the key character grown or transformed? What lessons have been learned, and what are the consequences of the story’s arc?
- Who is it for? What is the target demographic or audience? Will they care?
- What is the best analogy for the story? Can you describe it in comparative terms, such as – it is like Titanic, but….
- Who would you cast? Is there an actor or actress that helps conjure up an image and bring the idea/point to life? Who would be the perfect lead, friend, villain?
What is the setting? Where and when does it take place?

What is the tone and style? Is it a comedy, or is it action? Is it live action, or is it dominated by special effects?

MARKETING IDEAS (AKA PITCHING) — WHO SHOULD MAKE THE PITCH?

Who should make the pitch may seem like a simple or even stupid question, but from a marketing perspective the answer is not intuitively obvious. There are often four choices:

- The creator
- A creative executive at the company, who is good at pitching
- A senior management executive, such as the company president — someone with stature, and perhaps relationships
- An outside creative, such as the writer you would like to hire

There is no correct answer, and it is a business and important marketing decision to create the best match for whoever is taking the pitch. All of the following scenarios can and do occur.

**Example 1** — The creative executive likes to make the discovery, and may even want to claim credit. This is the needle in the haystack scenario: the creative executive likes to meet with the source, and if instead a company sends a smooth pitchman the idea may not stand a chance. The key to succeeding with this type of executive is to send the creator: the buyer wants to meet and discover the raw, creative talent. If the company does not believe the individual to be a good pitch person or spokesman, then there is always the option of sending along a chaper—one.
Example 2 — Send your best salesman. The best creative people are not necessarily the best -fronts for selling. If a key creative is an exuberant and charismatic pitchman then the company is lucky. Approach this type of sales from a common sense basis: Who on my staff can tell the best story, make me laugh, get me interested, and hold court to draw in a decision maker on the other side?

Example 3 — Send the top star from your creative roster. Often people pay respect to, and even buy, reputation. Send the person who is the most respected and provides the company and pitch the greatest credibility. The benefit to this strategy is that people will show up for the meeting. No matter how a meeting is set, time after time key decision makers bow out at the last minute and send screeners; then they can come back in and take credit if there is interest, yet distance themselves from having to say no face to face. If the key spokesperson at the meeting is a niche celebrity, a hot director, or an award-winning artist then the odds go up that people will take the meeting seriously.

Example 4 — Send a top executive. If the pitch is part business proposition (e.g., not only is this great, but we can do it cheaper...) and you believe the other side will be equally if not more motivated by the value added from the business side (especially if you are willing to co-invest or otherwise materially influence the economics and risks), then this can be important. This is especially true if the pitch is to a company or division president, as opposed to purely within the confines of a development department/creative executive.

Example 5 — Find a hired gun or partner. There is nothing wrong with admitting that you may need help. More projects are made because people associate themselves with others that can get a foot in the door than any other way. The downside is often economic, because if you
need to go to an outsider for help and they recognize that their reputation or clout is critical then they can ask for disproportionate compensation. Worse still, it is entirely possible that the individual hired may spend little time, have nothing to do with the project downstream, and make guaranteed money that exceeds whatever you may make for years. While seeming patently unfair, this is a compromise that many make in hopes that on the next project (with a hit under their belt) leverage will switch and they do not have to give up a chunk of the pie just to get in the game.

It is common in both film and TV to attach a writer at this stage, since the acquiring party will either want to commission a script or rewrite what has been created to date. If you are associated with a writer they want to work with, or they believe that the writer (either directly, or by reputation) will be able to bring something extra to the project, this can break the ice.

Again, because there is only one shot at pitching a property to a particular network, studio, or company, the marketing strategy needs to be carefully mapped out and executed. Who makes the pitch, and how it is made, can make or break a project regardless of the merits of the project itself. The notion that a project –is such a home run anyone could sell it— is simply a myth. And, it is a further myth to believe that addressing or being prepared for all of the questions previously outlined will sell a project. I could wax on about more rules (e.g., keep the pitch moving, do not get bogged down in details, be enthusiastic), but my point is to highlight the complexity of pitching and structuring a story, not to suggest that there are golden rules.
MARKETING IDEAS (AKA PITCHING) —
WHAT MATERIALS DO YOU NEED FOR A PITCH?

What materials are needed is again a marketing question. Different executives will prefer different presentations, and it may be nearly impossible to create the right package for the spectrum of pitches. There is no answer to what is “just right” but there are parameters of what is too much, too little, or too costly.

Too Little

Because we are talking about a visual medium, words are often not enough. At a minimum, there should be a “leave behind” that summarizes the (1) story, (2) where it came from, (3) who is involved, and (4) enough meat that a good portion of the story and selling keys previously discussed are addressed. This will be read if the project/you are taken seriously. Visual material is critical, and something must be presented to bring the concept to life. This can involve artwork, character designs, reference material, source material (if a public domain item or from a book), storyboards, and even video presentations. (See the Mini-Bible section.)

Too Much

Most people you would pitch to either have value added to bring or believe they have value added to bring. There is a fine line between selling an idea and having gone too far down the road. Also, more is not necessarily better, coming back to the importance of the one line pitch concept. People need to be able to flip through the materials, read a treatment, view art- work, and digest the project in a matter of minutes. If the material presented is so dense that it takes half an hour to go through, few will sit through the presentation and fewer will be able to make a similar presentation to their colleagues either upstream or downstream.

A further consideration is whether you are only pitching one property at a time. It is common
to make multiple pitches in a meeting, both to impress others with your creativity and range
and to hedge bets on what projects will strike a chord. There is nothing worse than a pitch
meeting that is cut short two minutes in with the dreaded –we have something similar to that
in development, what else do you have? If you are already famous and connected and have
come in to pitch one idea, this is forgiven; for the rest of the world this can be a disaster.
Hence, the materials must be weighty enough to convey and spark the story, but short enough
so there is time to pitch multiple ideas.

Too Costly

A corollary to too much is too costly. If too much time and money has already been in-
vested, and you are still at a stage where the next step is more development, then there is a
–sunk cost– risk that can arise. This is no different than any other business where a mini cost–
benefit analysis will be applied, and a decision made as to whether the project is unduly
burdened. The developing party needs to acknowledge this risk, and if it has made a conscious
decision to spend significant money already bringing the project to life, it must assume the
potential risk of writing off this investment; the goal is to recoup sunk costs and add them to the
overall cost of the project.

It can cost hundreds of thousands of dollars to perform a proper test, or piece together a
DVD presentation including models, voices, backgrounds, etc. This can make all the difference
and engage a buyer; it is simply more risky, and if you are insistent on recouping the costs up
front, it can be a deal breaker.

Mini-Bibles
If you are pitching certain types of TV shows, a bible or mini-bible may be standard. This creates a short leave-behind document that brings the idea to life and can be easily referenced and passed around for internal discussion. The leave-behind may include a short treatment, followed by a longer story outline, complemented by artwork and other information. These are examples of elements that may be included in a mini-bible:

1. Film
   - Proposed title
   - Characterization of genre
   - One-line premise
   - Story synopsis
   - Main character descriptions and artwork
   - Full treatment, or three act-type detailed outline
   - Background art to convey style and scope
   - Reference art if useful
   - Background on key creative people attached

2. Television
   - Proposed title
   - One sheet that gives a high concept verbal and visual description
   - One sheet or short concept treatment of series premise
   - Main character descriptions/profiles accompanied by visuals, showing range of
views/emotion of character

- Ancillary character profiles and visuals

- The show formula/how the series works (e.g., X will always solve a mystery)

- The setting
  - The educational value (if appropriate) or moral message

- Episode premises

**No Set Rules, No Right Answers, and Valuing Pixie Dust**

Again, because the ultimate product is an in-process creative item dependent on subjective judgment, there are no set rules and no right answers. Addressing a number of the previous concepts and questions, however, allows creators to customize a marketing plan for selling their ideas. If done properly the effort put into marketing will add professionalism to the creativity, helping to build relationships and be asked back again. The key to selling is not so much whether a specific idea will sell, but whether creativity is packaged in a way that the buyer believes he may like the next project you bring and believes you can deliver on execution.

If entertainment properties were merely widgets, then anyone could produce them. Because of the infinite variety of creative expression and the fact that nobody can predict with certainty what will work before the project is infused with its creative spark, however, what is most coveted and compensated is the belief that a certain individual will kindle that spark and therefore distinguish the outcome. In a sense, everyone believes there really is pixie dust, but no one can guarantee when and how it will be let loose.
PROTECTING CONTENT: COPYRIGHT, PIRACY, AND RELATED ISSUES — TRADEMARKS AND PATENTS

In the case of a movie, the studio or producer (whoever owns the merchandising rights) protects the specific product by registering its trademark (e.g., Batman logo) for use in association with a particular good or product (e.g., a toy). An important legal tenet of trademark law is that the product for which trademark protection is being sought is actually used (or will be used). Because trademarks exist to distinguish one brand from another, they cannot be defined in theory but rather must have actual real-world uses.

Trademark Registration; Costs of Maintenance and Administration

The trademark office divides products into a variety of classifications, such as for toys or clothing, or audio/visual software, and separate registrations need to be filed for each relevant product category. The process of registering and maintaining marks becomes an economic calculation: how many marks should be registered and in which category, as there are separate fees for each mark in each class.

Adding to the matrix of costs is that trademarks are territorially limited. For an effective worldwide program the same decisions need to be addressed on a country-by-country basis: How many marks should be registered, and in what classifications, in Germany? Taking the example of *Toy Story*, one could imagine the following:

Trademarks:

- Buzz Lightyear
- Woody
- Toy Story

Categories:
There are at minimum 10+ categories that would likely be covered from apparel, to toys, to games, to music.

Territories:

Disney has a world-class merchandising arm, and would likely register the marks in all major markets where it sells products. For simplicity, let us assume 20 countries.

That makes 3 marks × 10 categories × 20 countries = 600 trademark registrations. For a franchise as valuable as *Toy Story*, I would expect that this number may be low, and for a major franchise supporting a global licensing program it is conceivable for more than 1,000 marks to be registered.

The cost of the registration program is then made up of attorneys’ fees to file for and register the marks locally, as well as the actual filing fees. Then the process starts anew, as once registered, trademarks have a finite registration period and must be properly renewed to stay valid. In addition to the expense of maintaining registrations, which can be significant, there are costs to enforce trademark rights through legal action. It can take a worldwide army of trademark counsel to navigate the nuances of local registrations and maintenance, write cease and desist letters (putting sellers of products infringing trademarks on notice), and bring suits to enforce rights (as occasional lawsuits are necessary to cause infringers to heed warnings, and in the most egregious of cases to physically stop a product that may be damaging the market for legitimate products bearing the mark being infringed).

These actions then become staples of a trademark lawyer’s practice, which crosses over into litigation to prosecute third parties for infringement. The underlying theory of the cases is likely simple and harkens back to the central thesis of trademark law: Is there a likelihood of consumer confusion between the third-party product and the product owning the trademark
registration on its own article of merchandise? To continue with the *Toy Story* analogy, if a third party is selling a sweatshirt with a spaceman on the front that looks like a toy and has the same color scheme and bubble shaped helmet as Buzz Lightyear, such that the character depicted is similar enough to Buzz Lightyear that an average consumer is likely to think they are buying a sweatshirt with Disney’s *Toy Story* character on it, then Disney is likely going to enforce its mark and take action against what they view as an infringing property. Like all areas of intellectual property, the facts of each case are often determinative, and the ambit of how close is too close provides fodder for trademark counsel and legal scholars.

**Patents**

Like copyright, patent rights find their origins in the Constitution, which grants authors and inventors the exclusive right to their respective writings and discoveries in order to promote the progress of science and art. The difference between exclusive in this context versus copyright is that patents afford their owners a monopoly on the invention for a set period of time. The US Patent and Trademark Office (USPTO) summarizes a patent as

Sanctioned monopolies on the subject matter recited in the claims of the patent. A country’s laws accordingly grant a patentee a right within its territory to bar others for a set period of time (e.g., 20 years) from using, making or selling the subject matter disclosed in detail in the patent. When the set period of time runs out, the subject matter of the patent enters the public do-main and can be used freely by anyone in the territory.

Similar to trademarks, the USPTO’s Web site is a simple and easy way to gain basic
information.

The fundamental tenet for obtaining a patent is that the invention must be novel and non-obvious. While we tend to think about patents today in high-tech terms, some of the best examples of patents historically are more associated with innovation than pure technology, for example, the paper clip and zipper.

**Software Patents and its Increased Importance in Digital Processes**

In terms of entertainment, patents have always been important in production (think of camera technology) and are increasingly valuable in today’s digital world. Patents can be applicable in production (such as digital production utilizing computers and 3-D graphics), distribution (such as manufacturing processes, DVDs are an example of a patented technology), and exhibition (such as Digital Cinema and Imax, both of which rely on patents).

**Cost–Benefit Analysis of Whether to File for a Patent or Not**

To decide whether an invention in the entertainment arena, as well as any other field, is worth the investment of patent protection depends on the inventor’s economic agenda. There are multiple reasons why patents can add value to a company and why care should be taken to conduct patent audits and identify inventions:

1. The patent could be a source of revenue. If the patent is in demand by others, a licensing program can be established.

2. The patent could provide for a competitive advantage; there may be reasons to secure the rights but not to license the technology to others; as noted previously, patents are essentially a legal monopoly for a limited period.

3. If a company does not pursue a patent, a third party could develop something similar.
This leads to the fear of having to pay license royalties, or in the extreme case, potentially being put out of business.

4. There may be reasons to develop a portfolio of patents which, as assets, can cumulatively become even more valuable or are available to license in a trading context (cross-licensing) when seeking a license from a third party.

A few examples may be helpful to put these methods of exploiting patents into context. If a company wants to exploit its license, there are countless examples of entertainment companies profitably maintaining a licensing program. On the film production side, Pixar maintained a program for licensing inventions related to computer graphics production (its Renderman technology). On the distribution side, Lucasfilm’s company THX developed a program for licensing patents both for sound systems in movie theaters as well as for consumer electronic home theater systems. Dolby laboratories is another example of a company with a vibrant business built around patents (involving sound systems, both for theaters and consumer electronics/ stereos). In the games area, game platforms such as PlayStation and Xbox are based around Sony and Microsoft technology; game developers who enter into contracts to develop software for the systems and publishers/distributors are required to manufacture console units through these companies in part due to the underlying patent rights. Companies like Sony earn significant royalties off their patents, as well as control margins and profits on the manufacturing side.

Finally, in terms of a portfolio of assets, entertainment companies are valued by their libraries; the theory is that while people and talent can come and go, the underlying intellectual property assets (the library of film and television rights) have long-term residual value given the ability to continue licensing rights for the term of copyright (part of the so-called long tail). Pat-
portfolios are similar intellectual property assets valued for their ability to generate a continuing revenue stream. A company such as Pixar that has both patent and library assets may be much more attractive to investors.
CHAPTER THREE: Financing Production: Studios and Networks as Venture Capitalists

Examples of Prior Wanda Deals

Examples of Wanda Group and other Chinese companies led Entertainment/Media investments suspended or terminated after policy shift in 2017:

<table>
<thead>
<tr>
<th>Company</th>
<th>Date</th>
<th>Investment Details</th>
<th>Amount (Estimated)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Copper company</td>
<td>Dec. 2016</td>
<td>80 percent stake in Voltage Picture(^3)</td>
<td>$350 million</td>
</tr>
<tr>
<td>Anhui Xinke</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Wanda</td>
<td>Mar. 2017</td>
<td>Purchase deal of Dick Clark(^4) Productions</td>
<td>$1 billion</td>
</tr>
<tr>
<td>Recon Holdings</td>
<td>Aug. 2017</td>
<td>Takeover of Millenium Films through purchasing 51% stake of it(^5)</td>
<td>$100 million</td>
</tr>
<tr>
<td>Huahua Media</td>
<td>Nov. 2017</td>
<td>Co-financing arrangement, which would’ve covered 25% of Paramount’s film slate(^6)</td>
<td>$1 billion</td>
</tr>
</tbody>
</table>

Leveraging Production with International Coproduction Financing—the Wachowskis’

Experiment with Cloud Atlas

[Reproduced from the 2\(^{nd}\) Edition without modification]

International coproductions are the norm with films originating in Europe, as domestic markets
often cannot support the full costs of a high-budget film, especially when the cast/production is associated with a particular language. The film Cloud Atlas, an ambitious project of Andy and Lana Wachowski, the sibling team behind The Matrix series of movies, pushed the limits of independent international productions. With a reputed budget of $100 million and a blockbuster cast including Tom Hanks, Halle Berry, and Hugh Grant, among others, the film was a German–American–Asian coproduction not only with multiple locations, but also multiple principal crews and directors. Asian investors contributed more than one-third of the budget (approximately $35 million), which included substantial investments from South Korea (Bloomage Company, a Korean film distributor), Singapore (shipping magnate Tony Teo), Hong Kong (major film distributor Media Asia Group), and China (Beijing film company Dreams of the Dragon). Significant financing was also contributed from Germany, where subsidies (e.g., German Federal Film Fund) reportedly accounted for approximately $18 million; given that one of the film’s directors, Tom Tykwer, is German, the head of the German Federal Film Fund was quoted as saying, “From our perspective, Cloud Atlas is a German film.” Add to this that Warner Bros. is the U.S. distributor (at least as of the date of production was not a major financial contributor), the movie is a classic independent film, with sources cobbled together from global sources, set in multiple overseas locations, with investors from Asia, Europe, and the U.S. alike claiming pride of ownership.

What makes the financing truly unique, however, is that to weave this creative and financing quilt for a film that involves multiple interrelated stories (in different times and places), there were two different film units and crews shooting simultaneously. This production scheme maximizes the efficiency of shooting, with actors moving between different roles, even on consecutive days. In discussing the financing, the New York Times noted: “The idea of shooting
on parallel tracks, with the Wachowskis directing one unit and Mr. Tykwer the other, grew from a realization that the stars were more likely to work for a steep discount if the shoot could be finished in half the time. Actors also play different roles in different time periods, keeping them busy and, on certain days, turning stars into extras.”

Rent-a-Distributor: When a Producer Rises to Studio-Like Clout

[Reproduced from the 2nd Edition without modification]

The rent-a-distributor model is rarely used and limited to producers with enough of a checkbook and a track record that they can pay for production costs and bargain for reduced distribution fees. The most famous example of this model is Lucasfilm’s deal with 20th Century Fox for the three Star Wars prequels, The Phantom Menace, Attack of the Clones, and Revenge of the Sith. Due to the success of the original Star Wars trilogy, George Lucas had the financing and leverage to pay for the three prequels himself. Fox was reputedly investing no direct production costs, receiving a negotiated fee for distributing the Star Wars films. This arrangement of only earning fees without taking any risk, while the producer, in essence, utilizes the studio’s distribution operations (e.g., theatrical, video) and maintains the upside for having financed production, is often unfairly characterized as risk-free to the studio. By unfairly characterized, I mean that this premise tends to ignore the opportunity costs; Fox took on the responsibility and management of releasing these films, which was significant because they were destined to become the event titles of their respective years and require appropriate associated management and overhead time.

Presumably, the only reason a studio would agree to take on this level of time commitment is
if: (1) it was important to have a relationship with the talent and/or property; and (2) if it believed, even with no or minimal upside ownership stake, it could earn significant distribution fees. This latter point underscores that the films in question need to be of mega box office stature, which leads to the corollary benefit of the studio leveraging one of the most desired films in its portfolio. While packaging is theoretically illegal under antitrust laws prohibiting tying arrangements, if Studio X comes to a client with a slate of pictures and one of those pictures is a must-have picture, the wheels are greased for the other releases. All of these elements were satisfied: Fox had been the home/distributor of the original *Star Wars* films, clearly wanted to maintain a relationship with George Lucas, believed each film had the potential to generate hundreds of millions of dollars, from which it could generate significant fees, and was ensured of multiple tentpole releases anchoring its summer slate over a number of years (from which it could directly or indirectly leverage other films).

The reason a producer would want this type of deal is to maintain the upside and keep control over the property both creatively and economically. Talking about the arrangement, *Business Week* noted of Lucas’s control of the prequels: “He retains the rights to dictate marketing, distribution, and just about everything else about how they’ll be seen in theaters.”9 The deal was the envy of every producer that could afford to bankroll his production, and before Disney acquired Pixar the distribution deal being negotiated was publicly referred to as a “Lucas-type distribution deal,” where Pixar would pay Disney a modest fee and retain the upside profit.

Applying the above test, Disney was in a similar position with Pixar as Fox was with Lucasfilm: Disney wanted to continue its collaboration with Pixar (one of the most successful in studio history), believed it would earn significant fees from distribution (even with a significantly discounted distribution fee), and with the track record of past Pixar films knew it
would have a series of must-have hits that would help leverage its other films and businesses. The one significant difference, however, was that while Fox and Lucasfilm had been successful partners, Fox was not a brand inextricably tied with Lucasfilm. In the case of Disney–Pixar, the fact that Disney is a consumer brand heralded as synonymous with successful animation and that Pixar, for years, had been upstaging them and could have become a competitor was clearly a factor. One could argue that the deal took on overtones beyond pure current economics, and that more than a distribution relationship was needed to restore Disney to its glory and market leadership in the animation space. To the extent that Disney may not have been willing to take a sliver of the pie on a successful animated film as opposed to holding the full upside (including character/franchise rights to cycle through theme parks and other vertically integrated divisions), the scales were simply tipped in favor of a purchase (ironically, after Disney spurned a rent-a-distributor deal with Pixar and acquired the animation powerhouse, a few years later it acquired Lucasfilm).

Finally, even with all the clout in the world, a producer still needs the product distributed and cannot afford the massive overhead of a worldwide theatrical and video distribution team. Despite whatever Hollywood-hugging one may witness, this is a relationship driven by necessity, not love. It is this remaining underlying tension that fuels the passion for new distribution mediums, now enabled by digital technology, and holds the ace card of a producer bypassing the studio distribution system and going directly to the consumer. It is only the theatrical/video/TV infrastructure, marketing expertise and clout, and associated overhead costs that pose obstacles and require a partnership between production and distribution. What those who want to bypass the traditional studio system and distribute directly often fail to recognize is that the studios are quite good at what they do. Studios have become adept at efficiently creating brands overnight.
and repeating this feat on a regular basis. The infrastructure is not something to be dismissed lightly, for it is to the success of a film what an efficient supply pipeline is to a manufacturing endeavor; moreover, as discussed in Chapter 1, the efficiency is created by scale and cannot be repeated easily, if at all, on a one-off basis.

*Reduced Distribution Fees are Key to the Deal*

While the relative advantages detailed above are all important, it is key to remember that the heart of a pure distribution arrangement is the producer’s ability to lock in a below-market distribution fee. For this to work economically for both parties, it needs to be primarily a financially driven relationship and not a competitive one.

While market rate fees can be 30 percent and higher, a rent-a-distributor deal where the producer is providing all the financing can drive down fees to single-digit levels. DreamWorks Animation, in its SEC filing, noted that it had an 8 percent distribution fee with DreamWorks studio.¹⁰

While this could be perceived as a sweetheart deal between affiliated entities, it apparently set a benchmark for Steven Spielberg. When DreamWorks announced its split from Paramount in October 2008, backed by a reported $1.3 billion in financing from India’s Reliance Communications and debt raised by J.P. Morgan,¹¹ it lined up a distribution deal with Universal, the studio where Spielberg made *Jaws* and began his career. Commenting on the deal, the *New York Times* noted: “Under the terms of the seven-year deal, Universal will distribute up to six films a year, according to a statement by the studio and the film executives. Universal will receive an 8 percent distribution fee, according to a person briefed on the negotiations.”¹² Shortly
after this deal was announced, however, the Universal relationship fell apart and Dream-Works instead teamed with Disney, where the studio announced it would release 30 films over five years under its Touchstone Pictures label. Evidencing the difficult climate of raising financing at the time (even for Spielberg, the ultimate luminary in Hollywood), as well as the sensitivity of how low studios were willing to reduce their distribution fees, the New York Times later reported that DreamWorks would instead be paying a 10 percent distribution fee: “The percentage is more onerous than the company had expected at Universal.”

Funding Ensures Tapping into 100 Percent of Revenue Streams

As briefly discussed above, one of the principal advantages to funding all or a percentage of costs is that it tends to eliminate “Hollywood accounting” (see Chapter 10) and allows the backers to look to all revenue streams for recoupment and profits. Net profits definitions and participations are structured to define only a certain pot of revenues, such as video only being accounted for at a royalty percentage rate, rather than 100 percent of revenues. By partnering with a studio, a co-financier, if smart, stands in the same shoes as the studio; namely, they will recoup out of the same revenue streams and at the same time.

Financing of Online productions (historical/early days when shorts dominated)

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Financing shorter-form online programming ratchets down the risk yet another level. Compared to television, budgets are a fraction, which is due both to the fact that programming is shorter and the cost per minute of production is significantly less. While the cost-per-minute differential may
narrow as efforts are made to improve quality (see Chapters 6 & 7, regarding online leaders such as Netflix moving into original content), the shorter format most producers are adopting will continue to provide an advantage (although, it is possible on a cost-per-minute basis it could become more expensive, given there are less minutes to amortize, and series costs tend to be front-loaded). Accordingly, the sampling nature of the Internet coupled with shorter pilots means that online production may indefinitely remain lower risk versus film and television, provided that upsides materialize. One could argue that today the risks are higher because the revenue side remains immature and there are few proven models/examples of profit ability, regardless of how low production costs may be. This is why the business launched predominantly with VC-type backing, and why we have not seen the development of similar financing structures as in other media.

I previously asked the CFO of ABC, Jim Hedges (recently stepped down in 2012 after more than 15 years with the network), how he viewed the landscape and whether we would see online financing mechanisms start to mimic those found in TV and other traditional media, and he advised:

We’re at the beginning of real change in how consumers view television content. And the change is significant and will provide great new opportunities for media companies.

Historically, viewers consumed television content on the big three networks when it was programmed by a network executive. There were no other options. If you missed your favorite show Thursday at 9 p.m. on ABC, you had to wait for the repeat or you just missed it.

Today, consumers are programming their own “networks” by using the many options available to them, including watching it “live” on the network, watching it on their DVR,
their computer via the Internet, by downloading a purchased episode from iTunes, or on their mobile device. In the very near future, video-on-demand will also be another option available, and there will be others that follow. They can also buy the DVD of the season’s episodes shortly after the season ends.

All of these new platforms provide the opportunity for viewers to consume the shows they love when they choose to, wherever they are—all with the potential to increase viewing. Historically, fans of hit TV shows only watched six episodes on average. If that average increases with all of these new opportunities to view, then media companies can monetize the additional viewing.

Some of the new platforms also have the added benefit (yet to be realized) of being able to target advertising to specific demographic and psychographic breaks, in large part because we’ll be able to know something about that consumer, either by tracking where they go online or by asking them who they are. This should result in more efficient return on investment for advertisers, as well as higher ad rates for media companies.

In terms of financing, I believe the traditional methods will remain as viable options for big media companies. For online productions, I think it will be split into several buckets of financing: big media companies will finance online productions in a similar way to productions created for the linear television platforms, and may use online as a new development ground for TV shows; small production companies will develop and produce online content in a nonunion environment, funded by venture capital and other traditional sources; user-generated content will continue to grow as the price of entry continues to drop, although it appears to be difficult to monetize this content in the near term.
**Wanda Subsidy (estimate).**

The following is an estimate of the subsidy scheme offered by Wanda (as of 2018):

More on Wanda Subsidy

<table>
<thead>
<tr>
<th>Type of Production</th>
<th>Qualified Cost of Production(^{15}) (million RMB)</th>
<th>Subsidy Percentage</th>
</tr>
</thead>
</table>
| Chinese Production (Movie) | 8≤X≤20  
20≤X                                              | 30%  
40%                                               |
| Co-Production (Movie)    | 30≤X                                               | 40%                |
| Chinese Production (TV show) | 50≤X≤100  
100≤X                                           | 30%  
40%                                               |
| Co-Production (TV Show)  | 300≤X                                              | 40%                |

The Wanda subsidy may only be awarded after the movie is released and shown on screen. Till May 13\(^{th}\), 2018, only two movies received the subsidy due to this requirement, *The Great Wall* and *Pacific Rim*.\(^{16}\)
CHAPTER FOUR: Theatrical Distribution

Multiplexes and Bankruptcies of Major Chains

A number of factors led to a spate of bankruptcies of several major chains following boom years in the 1990s. Probably the biggest contributor was the simple fact that screens grew at a pace that far outstripped the rise in movie attendance. According to the National Association of Theater Owners (NATO), in the period from 1988 through 2000, the number of screens in the United States rose to approximately 37,000 from 23,000, representing a 61 percent increase, while theater admissions only rose by about 36 percent. The trend then leveled out, with screens flattening out and coming down only slightly from a 1999 peak to 36,000 as of the mid-2000s.¹⁷

This growth was spurred by the phenomenon of multiplexes, which could leverage common infrastructure (concessions, ticket sales, ushers) across multiple screens, and vary theater size, allowing them to match capacity to demand. This was a compelling economic proposition, but the eight- to 10-screen expansion seemed tempered compared to the next iteration of megaplexes. AMC, which originated the multiplex from a modest two-theater experiment, started the megaplex trend in 1994, building a 24-theater complex in Dallas. The megaplexes included now-common features such as coffee bars, stadium seating, and video arcades, and soon everyone followed.¹⁸ The total number of theaters ultimately contracted, as exhibitors abandoned leases and consolidated screens into larger multi-screen venues; according to NATO, the number of locations actually contracted from 7,151 to 5,629 in the decade following the advent of multiplexes (e.g., roughly from 1995).¹⁹ The contraction, though, was not enough to counter the
larger issue of a massive increase in screens, high operating costs from new megaplexes, and smaller percentage increases in ticket sales and price of tickets.

The net result was too many empty seats and too much overhead, a formula that led to the bankruptcy over time of most of the major chains, such as Loews Cineplex Entertainment, Carmike Cinemas, United Artists, General Cinema, and Regal Cinemas. In a sense, the economics of stadium theater venues are . . . like stadiums. Most of the time capacity is empty—some estimate that theaters operate in the range of 10–15 percent capacity (meaning most seats are empty most of the time)—and the key is maximizing consumption during peak full-capacity events (i.e., hits). This pattern means greater pressure than ever on turning over screens, as operators want something fresh to drive the audience, unable to afford to wait for a middling performer. Several years ago, the trend of declining screens halted, led largely by the growth of digital cinema. Whereas in 2005, when I was helping oversee the release of Star Wars Episode III (after George Lucas had pioneered the D-cinema trend and was pushing the industry to adopt the medium), and we continued to struggle to find venues with the count being around 100, by 2018 the industry had fully converted its 40,000+ screen base. In fact, the MPAA’s 2017 Theme Report notes that “At the end of 2017, virtually all of the world’s cinema screens were digital (98%), up one percent from 2017 (97%). The global share of 3D screens to all digital screens increased by three percentage points in 2017 to 59%.”

The Digital Divide and Growth of Digital Cinema

[The following is reproduced from the 2nd Edition without modification]

The Growth of Digital Cinema

George Lucas and Lucasfilm helped pioneer D-cinema by shooting Star Wars: Episode II – Attack of the Clones digitally and releasing the film on 60-plus digital screens in North America
in 2002. Much like Lucas had pushed sound presentation with his THX technology and business, D-cinema offered the potential of consistent picture quality. Given the lack of uniform standards, infrastructure, and others to come on board quickly, by the time *Star Wars: Episode III – Revenge of the Sith* came out three years later (May 2005), the amount of digital screens available had not appreciably increased.

With the studios banding together and setting standards in 2005 under the Digital Cinema Initiative (DCI) consortium, and the theater owners through NATO then building on the agreement and agreeing to specifications, the landscape was set for quick adoption and there was renewed hype. Despite this momentum, though, as of Christmas 2008 there were reportedly only approximately 1,000 screens out of the 35,000-plus screen universe in the United States equipped for digital projection.

Trying to make sense of the glacial adoption, I asked Tom Quinn, senior director of worldwide distribution for Lucasfilm—who managed multiple digital releases with different studio partners, and has had a catbird’s seat to watch the evolution of D-cinema—why he thought adoption had not yet, at that time, materialized. He advised:

The promise of D-cinema is undeniable from a long-term cost savings point of view for both studios and production companies. The challenges have been: Who will pay for it and whose technology will be used? As a comparison to what we witnessed in the home video industry, first with VHS versus Betamax, and more recently Blu-ray versus HD-DVD, the issues are much more complex. Exhibitors don’t really believe D-cinema will drive more ticket sales, and unless there is an impact on a game-changing scale as moving, for example, from cassette to DVD or black-and-white to color film motivating
the consumer, they don’t feel they should be the ones bearing the costs of converting
 cinemas. Added to this is a system that has been virtually the same for 100 years and
 continues to work well—the “don’t fix what isn’t broken” mentality is hard for the
 studios to overcome. This is especially true given the high upfront costs of conversion
 and the fact shifting technology could be outdated soon after multi-component systems,
 including servers, projectors, etc., are installed.

Against this backdrop, and just when it appeared that it could take years for momentum to build
 (even though most in the industry were continuing to herald the benefits), the tide turned—and
 what nobody could have anticipated was, once the trend started to take hold, how fast the overall
 landscape would shift: by mid-2012, more than 27,000 screens in the U.S. had been converted to
digital, and the Hollywood Reporter ran the shocking front-page headline, entitled “Fox Eyes
End to 35 mm Film Distribution in U.S.” The article began: “Fox has become the first major
Hollywood studio to officially notify theater owners that it will distribute all of its films
domestically in a digital format within the next year or two, bringing an end to 35 mm prints.”

Supporting this shift was the fact that by the end of 2012, there was a near-complete turning
upside down of the digital screen penetration chart: from only 14.2 percent of all U.S. screens in
2008 to 83 percent of U.S. screens by 2013. Further, the MPAA, in its 2012 Theatrical Market
report, noted that as of Q1 2013, more than two-thirds of the total 130,000 global cinema screens
had been converted to digital (a combination of either 3D or digital non-3D). (Note: In U.S.
screens by type, MPAA notes that in 2008, 5,515 were digital (both 3D and non-3D) out of
38,834 total screens, while in 2012, there were only 6,789 analog screens out of a U.S. screen
universe of 39,918.)
When I asked Julian Levin, who headed the DCI and serves as executive vice president, digital exhibition & non-theatrical sales and distribution at 20th Century Fox, whether this was over-exaggerated or whether we truly would see prints go the way of 8-track tapes, he noted:

Elimination of 35 mm prints is already underway, and Fox has already stopped supplying 35 mm prints to several markets in Asia. Furthermore, the U.S. will probably stop using 35 mm prints in 2013, and many other international territories are sure to follow in the next few years. Once digital projection gained traction, with the added benefit of 3D, the point of no return came very quickly, faster than most would have perhaps imagined just a few years ago. The phase out will obviously be market-dependent, but when you reach more than 80 percent conversion of screens within certain markets, the move to all-digital starts to become self-fulfilling and, certainly, prints will become a thing of the past in many territories in the next 2–5 years.

How did this happen? First, it is instructive to look at the absolute numbers. Figure 4.1 is a parallel chart of historical penetration and forecast growth as predicted by 20th Century Fox while the tide was turning. Figure 4.2 is a parallel chart of historical penetration and forecast growth as predicted by 20th Century Fox for the international market. Adoption of this scale required incentives to invest in the infrastructure, and the DCI was able to forge extremely productive partnerships between the content providers (i.e., studios) and exhibitors. The partnerships implemented what became known as “virtual print fees” to fund and amortize the cost of converting traditional cinemas to digital screens. The cost of conversion was reportedly very high—in the range of $80,000–100,000 per screen—and required some form of
partnership/incentive scheme. A type of catalyst was needed, not simply because of the absolute costs and other obstacles that had hindered adoption, but also because conversions were being urged during a period of market turbulence (namely, how would cinemas fare overall in the face of digital disturbance and new forms of access to content) and not long after the time that the majority of major exhibition chains had emerged from bankruptcy. Addressing the macro industry costs, *Time* magazine, in its annual (2006) “What’s Next” issue, interviewed George Lucas for an article titled “Can This Man Save the Movies? (Again?)” and succinctly attributed the delay to theater owners: “When they hear the word digital, they reach for digitalis. Already feeling the hit for the 13 percent slump in moviegoing over the past three years, they aren’t eager to spend the more than $3 billion or so that it would cost to convert approximately 36,000 film projectors to digital.”

The virtual print program was designed to solve the inertia by looking at the differential between the cost of a physical print (such as $1,000) and the lower cost of a digital print and contribute the savings (or at least a part of the theoretical savings) into a pool. The specifics of how that savings was funded was then the subject of negotiation, but the key element is that rather than simply pocketing the savings, the interested parties agreed to impute costs as if physical prints were still being used and utilize that related pool of money to incentivize and fund conversions.
2nd Edition Figure 4.1 Historical Penetration and Forecast Growth as Predicted by 20th Century Fox for the U.S. Market

Courtesy of 20th Century Fox.

Again, I turned to Julian Levin, who advised the following regarding the implementation of these virtual print fee programs:
In connection with financing the cost of digital projection systems around the world, Fox has made enormous efforts to create a business model that was extremely fair to exhibitors and with distributors contributing significantly to the cost. The business models varied and have evolved. Fox has created the following options for exhibitors:

- Fox has closed a good number of deals with third-party integrators in the U.S. as well as
internationally (some regionally around the world). These integrators would then arrange a structured financing scheme and contributions to the system cost and financing charges would be paid by distributors upon booking each movie on each screen (a “virtual print fee,” or VPF). These deals tended to be complex and required full transparency to recoupment (over 8–10 years), at which point the entire system cost be paid off.

■ Fox also made available “direct-to-exhibitor” deals, which were simplified, allowing an exhibitor to deal direct with Fox should the exhibitor elect not to go with a large third-party integrator. These deals tend to be structured where the exhibitor arranges the financing and Fox pays VPFs for a certain period of time, at which point the VPFs stop. These arrangements are subject to individual exhibitor issues, import duties, customs, taxes, and a variety of moving parts so the cost varies from one exhibitor to another and from one country to another.

■ In certain cases such as France, Italy, Germany, and Norway, the government got involved and provided a structure that exhibitors and distributors could participate in. Fox made accommodations for each of these nuances and guidelines.

■ Once the systems are paid off toward 2020, distributors should benefit from some 35 mm print cost savings, and exhibitors will have the benefit of automation, alternative content, live broadcast, and a host of other electronic efficiencies.

In summary, exhibitors have had ample opportunity to select what plan they prefer, and for those exhibitors who are still not prepared to move (quickly), they could well become a casualty of the global conversion to digital projectors.
The combination of virtual print fee incentives and related schemes (and one would suspect benchmarks requiring certain levels of conversion), spurred the market on from incremental growth to upwards of 1,000 screens/month, and the resulting overall shift in the market landscape as depicted in the charts above. At the same time, the introduction of 3D films, which require D-cinema, provided a further accelerant—a process that was helped significantly by *Avatar*, which put 3D on the map (see a further discussion regarding 3D below).

Systems, Standards, and the Challenge of Keeping Pace with Technology Advances

D-cinema requires four elements that did not exist historically: a digital projector, a server holding the movie on a file, a digital master, and a delivery mechanism to transfer a copy of the film onto the server (Figure 4.3). Over time, the costs will come down, and the economies of scale in converting the market has already materially reduced the average cost of converting screens; nevertheless, as discussed above regarding virtual print fees, significant upfront investment is required from all sides. The exhibitors need to install projectors and servers (which collectively make up a digital projection system), while the distributors need to create D-cinema masters and standardize delivery mechanisms to clone the master and upload a copy to the in-cinema server.

Standards are, not surprisingly, challenging to cement. This is, in part, due to politics—different groups, such as NATO (exhibitors trade organization) and the DCI, originally promulgated their own standards—and differing opinions on key experience elements such as resolution quality. The de facto resolution standard was JPEG 2000 (“2K”), although many have subsequently pushed for 4K projectors. An interesting question arises as to whether at some point improved
resolution is actually a negative: some believe that the 4K resolution is too high, creating an almost artificial, hyperreal, and defect-visible level. Nevertheless, technology is rarely held back and these complaints are not faint whispers, with 4K moving ahead.

![Diagram of D-Cinema Master, Server, Projector with [DCI standards] and [NATO Standards]

**2nd Edition Figure 4.3** The Elements of D-Cinema

Beyond the technical upgrades required to move to 4K, issues of frame rate and what is needed for 3D create additional wrinkles (e.g., if 60 frames per second is desired and installed base of D-cinema is 48 frames per second, then down-conversion is required).

*Theaters on the Ropes—3D and Needing a New Hook*

Against the backdrop of increasing piracy, flattening US box office (there are always year-to-year vicissitudes, but most would agree the heyday of growth is over despite 2016 yielding a record B.O. high of $11.4 B, with 2017 down a tick at $11.2B)) and increased competition from other media sources (including streaming and downloading to portable downloadable devices), there is a periodic chorus of calls to save the movies. At times, talking about the business almost as if it were a dinosaur, articles and experts often cite reasons for moviegoing (aside from quality arguments) ranging from “movies are produced for the big screen experience” to “movies are a
social experience.” The point is executives are increasingly defensive and theater owners rightly concerned. What will bring people into the theaters in record numbers when consumers have a 50-inch LCD TV screen with high-definition content and theatrical-like surround sound? Even studio heads acknowledge the high costs to a family to go to the movies versus renting (babysitter + four tickets + parking + food = $100+ versus SVOD rental at less than $5). No doubt theaters must provide an enhanced and differentiating experience to the moviegoer or else see a cannibalization of their box office.

D-cinema, and in particular 3D, was initially heralded as offering just this value-added experience. Beyond all the historical good reasons to go to the movies, and the quality upgrade of digital cinema, 3D was marketed as something new—one could claim it was back-to-the-future, 3D glasses and all. The argument was the glasses were better this time. Moreover, 3D was perceived as enough of a differentiator to raise ticket prices, to as high as $25, which would both offset the higher production costs of 3D plus help theaters defray the costs of digital conversion. In practice, the premium charged for 3D tickets is about $2–4 more than for traditional 2D. The hype was further validated by luminary directors speaking out in favor of 3D, including Peter Jackson, George Lucas, Robert Zemeckis and James Cameron.

James Cameron even announced all his future films would be 3D (his first non-documentary movie directed since Titanic being Avatar). Disney, which announced that all its future animated and Pixar films would be released in both 2D and 3D, even tried to co-opt the medium in its marketing by branding new releases as being in “Disney Digital 3D.” In an advertisement run by the International 3D Society (www.international3dsociety.com), George Lucas lent his support to the organization’s “Make it 3D” campaign: “Digital 3D technology is revolutionizing filmmaking the way sound did in the 1920s. It will someday become the big-screen standard for
presentation, with 3D replacing 2D the way color replaced black-and-white. It’s just a better way of looking at movies.”

Paralleling the rapid adoption of D-Cinema, seemingly overnight 3-D became standard, first by the juggernaut of Avatar (becoming the all-time box office king, and garnering upwards of 70 percent of its box office from 3D releases), followed by the huge success of Disney’s rerelease of The Lion King in 3D ($172 million worldwide, and $94 million domestically). Presumed blockbusters lending themselves to the medium (e.g., Star Wars: The Force Awakens, The Last Jedi) are now by default expected to be available in 3D versions. What has changed, however, is the push to produce in 3D for the sake of it: 3D is no longer a fad or savoir, but a more expensive (to produce and to consume) version that will be demanded of certain film types and fan bases.

In some sense, the 3D success and the conversion of screens to D-cinemas were symbiotic. On the one hand, a couple of high-profile pictures, the most prominent being Avatar, demanded the conversion, because 3D requires compliance with D-cinema specifications. On the other hand, among the benefits of baseline D-cinema conversion was then the relatively simple upgrade to offer 3D—and therefore exhibit moneymakers such as Avatar. To offer 3D in addition to D-cinema requires a lens that pulls across the projector and creates the polarization and depth; this, combined with the polarized glasses, which divides the 48 frames per second into two, creates the 3D effect. Accordingly, a theater needs both the equipment and the glasses—an incremental cost that is currently funded and passed on via the higher ticket prices charged for 3D admissions. Overall, the growth in 3D screens has been astounding, and as evidenced by the above MPAA chart largely parallels the phenomenal growth of digital screens generally.
Major Theater Chains in China

As of January 2018, Wanda Cinema remained China's largest film distributor. Till January, 2018, Wanda Cinema had 525 cinemas with 4648 screens worldwide. The revenue in 2017 is 13.2 billion yuan. (Data from Wanda official website)

2. Shanghai United Circuit
3. China Film Stellar
4. Da Di Theater Circuit
5. China Film South Cinema Circuit

Brief Overview of Movie Theater Chains in China

As would be expected, theatre chains have grown over the last decade with the rise of the Chinese box office.

2017 data estimated.
The shortest bar (37-50) is the number of urban theater chains, the middle (218-325) is number of rural theater chains, and the largest represents the total amount of theater chains.

**Source:** QianZhan Consulting institute, data collected from open data.ne theater chain.

**History and Trends:** The theater chain system in China has developed with the guidance of the Chinese government since 2001. Under current policies, essentially every cinema must be connected with one theater chain. As of 2018, according to QianZhan institute’s analysis, the amount of urban theater chains has saturated, and though the amount of rural chains is still growing, it is to a degree linked to effect of this policy.

The biggest Theater Chains are as follows:

1. Wanda Film
   
   As of January 2018, Wanda Cinema remained China's largest film distributor. As of the beginning of 2018, Wanda Cinema had 525 cinemas with 4648 screens worldwide. The revenue in 2017 is 13.2 billion yuan. (Data from Wanda official website)

2. Shanghai United Circuit

3. China Film Stellar

4. Da Di Theater Circuit

5. China Film South Cinema Circuit
Screens Per Location

In terms of the facilities/screens per location, Wanda has been focusing on theaters with more than seven screens. Other theater chains tend to open four to six screened theaters.

Theater Chains Becoming Public Companies

Several theater chains have taken advantage of the growth of the domestic industry to access capital markets. For example, Wanda, Jinyi, Hengdian, are successfully listed, leveraging capital market financing to expand their market share/distribution/scale.

Top Production Companies in China

The following is an estimate of the top local entities based on recent performance and relationships:

| TOP MOVIE PRODUCTION COMPANIES by performance in 2017 |
|-----------------|------------------|-----------------|
| Company         | Movie            | Brief intro                                             |
| 1               | H. Brothers      | *Mr. Six*  
*Youth*  
*The Ex-File: The Return of the Exes* | In 2004, Warner Brothers, China film group and hengdian group jointly funded the establishment of China film warner hengdian film and television co., LTD., which is also the first sino-foreign joint venture film company. |
| 2               | Wanda Cinemas    | *The Great Wall*  
*Operation Red Sea*  
*The Man From Macau*  
*Operation Mekong*  
*The Founding of An Army* | |
| 3               | Bona Film group  |                                                             |
| 4               | ENLIGHT MEDIA    | *your name*  
*Detective Chinatown Vol 2* | Established in 1998, has become the largest private media entertainment group in China after 19 years of development. Main business includes TV program production and |

70
The chart below is ranked by date of establishment, influence and size. This ranking could be considered as based on traditional knowledge, because many of the films are older and “classic”. Accordingly, some may deem this chart as most helpful in gaining a general look at the industry, but perhaps not as helpful for predicting trends.

**Top Movie production companies**

<table>
<thead>
<tr>
<th>Company</th>
<th>Movie</th>
<th>Collaboration with US Studios</th>
<th>Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>China film group Corporation (CFG)</td>
<td>American dreams in China, So Young, Love and Let Love</td>
<td>1. Gone Public in 2016 2. The only company with movie import rights</td>
<td></td>
</tr>
<tr>
<td>ENLIGHT MEDIA</td>
<td>The Breakup Guru, Lost In Thailand, The Mermaid</td>
<td>Gone Public in 2011</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Company</td>
<td>Movies</td>
<td>Financial Details</td>
</tr>
<tr>
<td>---</td>
<td>--------------------</td>
<td>--------------------------------------------------</td>
<td>-----------------------------------------------------------------------------------</td>
</tr>
</tbody>
</table>
| 3 | H. Brothers        | • Devils on the Doorstep  
• Sorry baby  
• A World Without Thieves  
• If You Are the One | 2015, signed agreement with STX to collaborate on 18 movies, investing around 1 billion USD a year.¹ | Gone Public in 2009 (Growth Enterprises Market) |
| 4 | Bona Film group    | • The Man From Macau  
• Operation Mekong  
• The Founding of An Army | Invested 235 million in the production of over 20 movies by TSG Entertainment (close ties with 20th century fox), including Dawn of the Planet of the Apes, Martian. | Gone public in 2017 |
| 5 | Shanghai Film Group Corporation (SFGC) | • Fatal decision  
• Shanghai Story |  | Gone public in 2016 |
| 6 | Wanda Cinemas      | • Goodbye Mr. Loser  
• Detective Chinatown | 2012 Wanda’s acquisition of AMC, at approximately US$2.6 billion. | Not public yet |
| 7 | Le Vision Pictures | • The Great Wall | 2015 announced agreement with Lionsgate, Dark Horse Comics and director Rob Minkoff¹ | Public |
| 8 | EDKO Films LTD.    | • Fearless  
• Crouching Tiger, Hidden Dragon  
• Lust |  | Public |
CHAPTER FIVE: The (Non-Download, Non-Streaming) Home Video Business

[The following is reproduced from the Second Edition without modification]

Early Roots: Format Wars and Seminal Legal Wrangling, including the Sony Betamax Decision

The first consumer-targeted videocassette recorders were marketed in the 1970s, when Sony introduced the Betamax VCR. The introduction of the VCR faced the same chicken-and-egg dilemma that now seems commonplace with every new technology targeted at consumers’ consumption of entertainment: Was there a match between the hardware and software base? When Sony’s system was introduced, there was essentially neither software nor hardware available, much like the problem facing the launch of the DVD industry 20 years later in the mid-1990s.

To overcome such a hurdle, at least one party needs to take an enormous risk. In the case of the DVD, it was Warner Bros. leading the charge (see page 212 2nd Edition, “Early Stages of the DVD: Piracy Concerns, Parallel Imports, and the Warners Factor”), but the true early pioneer of the business was Sony in the days of the Betamax introduction. Interestingly, and disproving the first-mover advantage, despite building the market (and to many having a superior format/product), Sony did not emerge as the leader.

Sony’s visionary idea was that consumers would pay to be freed from television’s broadcast schedule (sound familiar today?): the Betamax VCR would allow them to watch programs when they wanted, not as dictated by the network’s broadcast schedule. The VCR was not originally positioned as a playback device for movies. Sony’s CEO, Akio Morita, said at the time: “People do not have to read a book when it’s delivered . . . Why should they have to see a TV program when it’s delivered?”26 Accordingly, Sony marketed the Betamax VCR hardware player, which
utilized a proprietary tape generically called the Beta format. Its marketing campaign echoed Morita’s theme, pitching the player as a machine allowing consumers to “time-shift”: consumers could record television programs and view them later at a more convenient time.

Whether history is repeating itself or technology advances enabling services such as Hulu are finally realizing Morita’s original vision, it is clear we are now on the threshold of totally taking the programming out of the broadcast scheduler’s hands. As alluded to in Chapter 6 and further discussed in Chapter 7, not only have DVRs made recording easier, but we can now envision (and, in fact, already experience) future iterations where TV is consumed in a playlist fashion, where viewers through VOD or other access select the programs they want to watch and then consume them according to their own programming schedule (which may be optimized or random).

Returning to the roots of the business, two factors greatly contributed to the explosive growth of the VCR market. First, and a point not often cited (and I will admit somewhat subject to challenge), the advent of the VCR was in the same general period as the emergence of cable TV in the U.S. Not only was the notion of time shifting attractive, but it was even more attractive in an environment of blossoming program choices. For decades, U.S. consumers were limited in programming choices to the three major broadcast networks plus a handful of local UHF stations; with cable TV came an explosion of choice.

Second, and more importantly, the ability to rent movies from video stores caught on like wildfire—the concept of building a library of tapes and renting tapes out for a price no more than a movie ticket proved revolutionary. Independent stores, which quickly gained the industry nickname “mom and pops,” led the growth and proliferated throughout neighborhoods. It was an ideal small business, preying on pent-up demand and taking advantage of modest start-up costs
(including the need for limited space); further, video rental was a cash business that built a loyal customer base virtually on its own via a regular supply of new product.

As great as this seemed for Sony and the new breed of video rental entrepreneurs, the whole notion of video rental seemed a looming disaster for the Hollywood studios who produced the films. The studios saw the VCR as a means of copyright infringement. The underlying economic fear was that individuals would copy movies and TV shows (and keep them for a home library), which would undermine the market to exhibit the programs on television. Universal’s president, Sidney Sheinberg, upon seeing the Betamax time-shifting campaign, and fearing the loss of revenues that could lead from unauthorized copying of Universal’s product, sued Sony for copyright infringement.

The resulting case, which was initially brought in 1976 and ultimately decided by the U.S. Supreme Court in 1984, was a landmark lawsuit that paved the way for DVDs, arguably saved the studio system, and is once again being pointed to as threatening the integrity of the distribution system (as new online services push the VOD envelope).

The Betamax Decision: Universal v. Sony

The ultimate finding in what has come to be known as the “Sony Betamax” case is that time-shifting via home copying for noncommercial purposes was permitted (in legal jargon, a fair use and non-infringing of copyright; for a further discussion of copyright, see Chapter 2). Before the Supreme Court reached this verdict, Sony Corp. v. Universal City Studios27 went through a litany of phases, with each side supported by name-brand media allies. Universal was joined by Disney, who saw similar infringement of its copyrights and potential loss of television broadcast
revenues. Sony was supported by the sports leagues, including commissioners of the national football, basketball, baseball, and hockey leagues; these leagues believed that VCRs were a benefit to live events, allowing fans/consumers to see games they would have otherwise missed. Another important Sony supporter was the Corporation for Public Broadcasting, believing that it was a good thing for children to be able to see educational programming and that VCRs promoted this end; further, it was endorsed by Fred Rogers, the star/producer of the classic preschool show *Mister Rogers’ Neighborhood*.

In the end, after an eight-year legal odyssey, the Supreme Court reasoned that a significant number of copyright owners would not object to their content being time-shifted, that there was insufficient proof the ability to time-shift would undermine the value copyright holders would receive from licensing their content to TV (which proved to be true, as license fees increased over the following years), and therefore the Betamax was capable of “substantial non-infringing uses.” Interestingly, the Supreme Court, in an almost prescient statement recognizing that new technological advances—advances like the Internet, file sharing, and VOD access via social media, of which it could not have been aware—would force it to consider the broader issues in the future:

. . . One may search the Copyright Act in vain for any sign that the elected representatives of the millions of people who watch television every day have made it unlawful to copy a program for later viewing at home, or have enacted a flat prohibition against the sale of machines that make such copying possible.

It may well be that Congress will take a fresh look at this new technology, just as it so often has examined other innovations in the past. But it is not our job to apply laws that have
not yet been written. Applying the copyright statute, as it now reads, to the facts as they have been developed in this case, the judgment of the Court of Appeals must be reversed.

It was a close decision (5–4), and whether or not one agrees with the logic (or cynically believes that the court needed to craft a political opinion, allowing the flourishing video business to continue), the video business was officially sanctioned. By 1986, just a couple of years after the landmark Sony decision, combined video rental and sales revenues ($4.38 billion) exceeded the theatrical box office ($3.78 billion) for the first time. By 1988, rental revenues alone ($5.15 billion) exceeded the theatrical box office ($4.46 billion).28

Among the ironies of the case is how the party most vested in the case (Sony) ended up losing the battle for consumer dollars, and how the plaintiff (Universal) came to be bought by one of the hardware manufacturers that benefited from the verdict. Matsushita, the parent of the Panasonic brand, and sister company to JVC (together with nonaffiliated Hitachi), developed and marketed the rival VHS format, which was incompatible with the Sony Betamax player. It was the VHS format that took hold and, by the mid-1980s, dominated. Video retailers did not want to stock alternate formats, and as VHS players became more dominant, more VHS titles were stocked and the spiral grew until Sony’s Beta format was doomed. Within a few years of the Sony v. Universal decision, Sony threw in the towel and started manufacturing VHS players. Perhaps adding injury to insult, only a few years later the format war winner Matsushita bought MCA/Universal in an acquisition touting the merger of hardware and software.

The Sony Betamax case continues to mark an important turning point for the distribution of content onto in-home hardware, as well as serving as a precedent for the current age of digital age cases such as Napster, Grokster, and Cablevision (see Chapter 2).
The Early Retail Environment: The Rental Video Store

[The following is reproduced from the Second Edition without modification]

When videocassettes were new, and market penetration of VHS recorders was growing in the 1980s, the video business was almost entirely a rental business. By rental, I mean conventional rental stores such as Blockbuster Video or Hollywood Video (household brands that many under 25 may now not know).

At first, when the rental market was exploding, it was dominated by neighborhood video stores. The economics were relatively simple. The video store would buy units of movies from the studio distributor, and then rent the cassettes out to customers. The store would perform a simple break-even analysis of how many times a particular unit would need to be rented to turn a profit. There were some add-ons to mimic movie environment, such as selling popcorn or candy to take home with your movie. Marketing was relatively unsophisticated, led by film posters supplied by the studio distributors to advertise the hit and coming films.

As the business grew, chains formed and eventually dominated. At first, it was actually an acceptable retail strategy to be out of stock. If a store did not have enough units of a title, people would rent something else and come back for the other film; disappointment was a fundamental and accepted marketing strategy. This allowed the store to profit on two fronts: retailers could keep inventory down, not making risky decisions of possibly overbuying on a title, while virtually assured of repeat-customer business.

For a period, consumers seemed to accept the delay as part of life, and would happily rent a movie other than the one they had come in for. The out of luck, but somehow not entirely dissatisfied, customers would come back for the film they really wanted when: (1) the store called to let them know the title was back in stock (if they had placed their name on the reserve
list); (2) at a somewhat random later date in the hope that they would be lucky and a copy would be available; or (3) at an even later date when they felt demand must have waned and they would have a really good chance that the title would be available to rent.

Amazingly, this lottery style mentality to renting did not dissuade consumers, and to some degree it helped fuel the growth and diversity of content offered by video retailers. Video stores recognized this phenomenon and were pleased for customers to rent a second- or third-choice title; as previously noted, this virtually guaranteed repeat business when the consumers returned the title they rented, but had not really wanted, and came back to rent the film they had come for in the first place. As a business model, this was almost too good to be true. Whenever one can make this type of statement, though, change is afoot. With the maturity of the business, impatience grew and consumers no longer accepted dissatisfaction as the rule.

Over time, rental stores became more competitive and needed to develop more traditional marketing campaigns to ensure customer loyalty. All types of schemes were implemented, from “rent 10 videos, get one rental free” loyalty programs, to store clubs that came with discounts, privileges, and mailings. More sophisticated chains divided customers into complex marketing matrixes, looking at who were frequent renters, casual renters, deadbeat clients, etc., and devising targeted campaigns to increase rental frequency and store loyalty. As the chains grew, they also started to advertise directly, advising customers “Come to Blockbuster and rent . . . ,” growing their business with an injection of direct marketing dollars plus cooperative marketing spends set out in their agreements with the product suppliers. As in any other product category, choice, growth, and competition added complexity, and rentals started to have price differentiation. Examples of offers included: “buy two, get one for free” deals, keep the title for the same price for the weekend, and rent new titles at full price for one night while offering older
titles for the same or lesser costs to keep for three or five days.

Finally, as a tangible example of the market maturing and retailers acknowledging that disappointing customers was not the best long-term strategy, marketing schemes shifted 180 degrees to implement guarantees that new titles would be in stock (and, if not, the rental would be free). When a new title came out, there would often be pent-up demand similar to that which creates lines at movie theaters. To the “I’ll wait to see it on video” crowd that had socially developed in response to the growth of the industry, the video release date was like a premiere. New titles, which a few years earlier would be gulped up the moment they hit shelves and be out of stock, would now be available in large quantities.

This marketing shift also had a direct economic consequence on competition. To satisfy demand, a store needed to have key new titles in sufficient quantity, which required a larger upfront investment. Whereas 10 or 15 copies may have been fine before, 10 times that number would now be required. An average retail price, which, at the time when rental was king in the 1980s and early 1990s, was approximately $70–$100, could change the inventory investment for one title from $700–$1,000 to over $10,000. Volume discounts may have allowed some lower average pricing, but the elasticity was not great and the net effect was pressure squeezing the smaller, “mom and pop” accounts. Not surprisingly, this timing coincided with increased clout from major chains, such as Blockbuster and Hollywood Video, which had begun expanding and gobbling up smaller outlets to become independent market forces. Between 1987 and 1989, Blockbuster grew from a 19-store chain to over 1,000 outlets, and in 1988, with just over 500 stores, became the country’s top video retailer, with revenues of $200 million; growth did not slow down, and through further expansion and acquisitions the chain grew another 50 percent to 1,500 by 1991 before finally being acquired in a merger with Viacom in 1994.29 The market was
vibrant enough that, with enough stores, chains could go public, and rival video chains Hollywood Video and Movie Gallery both completed public offerings in the early 1990s.

And change was just beginning. The dominance of the rental store was about to give way to the sell-through market, with rental revenue sharing becoming an intermediate solution to lower-priced units in a still-vibrant rental market.

Transition from Rental to Videos for Purchase: Retail Expands to Accommodate Two Distinct Markets for Video/DVD Consumption (including key factors driving growth in the sell-thru market)

[The following is reproduced from the Second Edition without modification]

During the growth of the rental video market, a new pattern was slowly emerging that would ultimately overwhelm rental sales and even threaten to eliminate the rental store completely: direct sales of videos to consumers. In trade lingo, this became “rental versus sell-through.” Today, the rental store seems to be facing extinction, combating the dual forces of downloads for purchase—“electronic sell-through”—and VOD access for rentals (both forces are discussed in more detail in Chapters 7 and 8, and serve as fodder for analysts who forecast new technology applications leading to the demise of historical markets).

The challenge in this earlier battle for survival was not played out as a public drama, as sell through was not initially perceived as a threat to rental’s dominance. In fact, conventional wisdom questioned whether consumers would want to purchase a videocassette when it had become so easy and relatively inexpensive to rent a film. One threshold issue was: Would people really want to watch a particular movie more than once? The general consensus was no. Those
customers who were passionate about a particular movie might rent it a few times, but for the rental store, which had invested substantial sums per copy of a title, there was every incentive to entice these fans back to re-rent the title.

For the video store, the game was still all about amortization of inventory cost based on turn: How many times did an individual cassette/copy need to be rented to break even? Obviously, it was an attractive business model to turn a copy many times rather than sell it once. Simply, if a copy of a blockbuster cost the rental store $50, and the outlet charged $5 per rental, the store needed to rent that copy 10 times to recoup. Moreover, because each film is unique, inventory obsolescence only applied to the physical materials (e.g., how long a cassette could be rented before the tape quality degraded to an unacceptable level). A title that had paid for itself could sit on the shelf as catalog inventory, providing pure profit for the indefinite future (subject to the number of copies originally stocked, as a store would obviously keep fewer copies in catalog than were acquired during the peak rental period of initial video release). In fact, one might say this was the first iteration of the “long tail” now so commonly discussed online. Accordingly, a hit title that needed 7–10 rental turns to recoup might have multiple future rental turns left, yielding more than a 100 percent return on investment on a per-copy basis.

If a title was able to generate over 100 percent ROI, then the business model to sell that unit was initially far from compelling. Ultimately, the model comes down to the simple elements of units and pricing. At the early stages, the cost per cassette made it difficult to create a margin allowing for markups to challenge the relative earning power of a rental unit. Even at a substantial markdown, such as to $20 inventory cost, the retail pricing was quite high; moreover, there was a disincentive to lower pricing significantly when the rental business was thriving. A bigger obstacle, however, was simply the pattern of consumer consumption. The whole video
market had exploded seemingly overnight, and people were used to renting, not buying.
Something would have to fundamentally change to shift that pattern, including a dramatic lowering of inventory cost.

2nd Edition Table 5.1 U.S. Retail Home Video Industry ($ billions)

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</tr>
</thead>
<tbody>
<tr>
<td>Video Rental</td>
<td>8.3</td>
<td>8.2</td>
<td>8.1</td>
<td>7.8</td>
<td>7.7</td>
<td>7.0</td>
<td>6.0</td>
<td>5.2</td>
<td>5.0</td>
</tr>
<tr>
<td>Video Sell-Through</td>
<td>12.6</td>
<td>13.5</td>
<td>16.2</td>
<td>16.4</td>
<td>16.5</td>
<td>15.7</td>
<td>12.1</td>
<td>10.5</td>
<td>9.1</td>
</tr>
<tr>
<td>Total Video</td>
<td>20.9</td>
<td>21.7</td>
<td>24.3</td>
<td>24.2</td>
<td>24.2</td>
<td>22.8</td>
<td>18.1</td>
<td>15.7</td>
<td>14.1</td>
</tr>
</tbody>
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Not surprisingly, though, as in most consumer goods markets, prices inevitably started to come down. This was forced by pressure from large chains that demanded lower pricing for buying greater depth of inventory. More important than pressure from the rental stores, however, was the fairly rapid market shift from a predominantly rental business to a retail-dominated industry. Just like renting had before, buying videos became a quickly adopted consumer behavior.

By the time the DVD market reached its peak in 2004–2006 (see the next section), and as evidenced by Table 5.1, the percentage of sales for sell-through had shifted to close to 70 percent, whereas only a few years before the split was nearly even.

Key Factors Driving Growth in the Sell-Through Market
Among the key changes driving the growth of the sell-through market were: (1) the growing trend for consumers to collect videos; (2) the decline in pricing, allowing consumers to purchase titles for the same amount of money as (or at least not much more than) a record/CD; (3) studio efforts to sell mass volumes of select hit titles; and (4) the growth of the kids video business, initially led by Disney.

Examining these factors in a bit more detail, as the pattern of watching and renting videos matured, people started the habit of collecting titles. Although now accepted as commonplace, this was hardly an inevitable turn. Market research will tell that most purchased videos sit on the shelf: How often do you re-watch a movie that you have bought? For some favorites and classics, of course, the answer may be yes, but once collecting transitions from buying your favorite film to a habit, the answer will likely be different. And that is the key—becoming a habit—seducing you to purchase titles that do not quite make your top all-time list. As collecting became in vogue, studios started to mine their libraries and make older titles available, expanding the range of consumer choice. First there were books, then records, and now videos; in fact, the lingo that evolved was “video libraries.” People started to buy videos, sometimes never even watch them, and keep them on the shelf as a new sort of trophy or archive.

And once a piece of media becomes a collectible, it becomes a gift, opening an entirely new marketing direction for sales. Studios, if nothing else, are brilliant marketing machines, and all video rights holders drove a truck through the opportunity to encourage sales as gifts. The fourth quarter is now the largest period for video sales (with the holidays an ideal time to launch gift sets and special editions), which is a far departure from the origins of the video rental business.

Second, and somewhat hand in hand, the market saw a reduction in pricing and a corresponding upturn in sales of mass volumes of a title. By the early 1990s, as the rental market
was maturing and chains grew and consolidated, there was a rule of thumb that you could place 200,000 to 300,000 units of a key new title in North America. For a title that was not a hit or one without a star driving sales, this number could be halved, while a big hit might sell twice this number of units. The key point is that there was limited elasticity of volume in rental.

Studios salivated at the notion of selling millions of units of a title, and on big hits it became commonplace to run break-even comparisons to assess how many units would need to be sold at retail to justify a “sell-through” release (sales direct to consumer as opposed to rental). While sell-through means direct sales to consumers, what it implicates at the distribution level is a whole new set of pricing and a dramatic expansion of retail outlets. The retail infrastructure for direct-to-consumer sales had to be built, and the expansion of outlets to mass merchants, drug stores, supermarkets, record stores, and independents took years to mature. In point-of-sale terms, this could mean going from low thousands of outlets at video rental to over 30,000 outlets for direct-to-consumer sales.

The challenges that came with the sell-through market were the same as any other consumer product: inventory management, advertising, in-store merchandising, physical distribution, and order of magnitude issues in physical manufacture. This was a daunting and, at some level, risky challenge for an industry that was thriving on limited distribution to a finite group of key customers, and where inventory management (video rental was largely a no-returns business) was a relatively minor issue.

So, putting aside the growing pains of becoming another consumer product challenging soap for advertising time and store shelf space, the nuts-and-bolts question became: What was the multiple needed to sell at sell-through versus a rental release? An important, and to the studios somewhat comforting, element in the matrix was that rental was still important. On any title
significant enough to justify a sell-through release, there was a built-in sale to all video stores. The studio could still sell its few hundred thousand units into the channel; it would simply earn a significantly lower margin, charging a wholesale price of $15–20+ as opposed to the highly profitable $50–70+ rental price. For a period, and for many years following in several international markets, there was even the ability to price differentiate. The supplier (i.e., studio) would charge a higher price for rental units sold to video stores, and create a separate, lower suggested retail price (SRP) for mass-market sell-through buyers.

The analysis was then a straightforward break-even equation, taking into account the sales uplift needed from a lower-priced good to surpass the revenue and contribution margin of the higher-priced, lower-volume rental units (with variable manufacturing and marketing costs factored in on the expense side). As a rule of thumb, it turned out that a title needed to sell a roughly 4:1 or 5:1 ratio to justify a sell-through release.

The ultimate accelerant for the sell-through market was kids videos, in particular the emergence of Disney as a dominating force via its video division, Buena Vista Home Entertainment. Earlier, I pointed out the issue of whether people would watch a video repeatedly; the one area where this was clearly true was with children. Simply, kids would watch the same video over and over and over. It does not take a brain surgeon to recognize as a parent that buying a cassette for $20 that your kids will watch seemingly 100 times is a good investment. To the parent that can gain an hour or more of near-guaranteed peace and quiet, the value of the purchase is worth infinitely more than the cost. Hardly a babysitter could trump the satisfaction of a Disney video, and the combination of a babysitter and a Disney classic was as good a bet as there was out there.

Disney quickly recognized the gold mine that lay before it, and the timing not so
coincidentally dovetailed with the reinvigoration of its animated film business. With hit after hit, commencing with *Beauty and the Beast* in 1991 and *Aladdin* in 1992 (see Table 5.2), Disney was validating a new market and spinning box office gold both in theaters and then again on video—a classic example of repeat consumption as a key factor in maximizing value per Ulin’s Rule. Then, in 1995, *The Lion King* broke out of the box, reportedly selling a staggering 30 million units,\(^{30}\) with reputedly 20 million units in its initial release window. The notion of 20 million units of a title had been seemingly unimaginable previously, and once the pattern of high volumes proved repeatable, there was no stopping. It continued for more than a decade, with *Finding Nemo* selling 20 million combined DVD and VHS units in its first two weeks of sales in November 2003, including 8 million on its first day of release for a record beating the prior *Spider-Man* tally.\(^{31}\) Everyone tried to jump on the bandwagon, but during the 1990s growth spurt, Disney seemed to have a lock on printing money between box office success of animated titles and the amazing upside that the video industry provided.

2\(^{nd}\) Edition Table 5.2 Disney Animated Releases by Year

<table>
<thead>
<tr>
<th>Year (Theater)</th>
<th>Title</th>
</tr>
</thead>
<tbody>
<tr>
<td>1989</td>
<td><em>The Little Mermaid</em></td>
</tr>
<tr>
<td>1991</td>
<td><em>Beauty and the Beast</em></td>
</tr>
<tr>
<td>1992</td>
<td><em>Aladdin</em></td>
</tr>
<tr>
<td>1994</td>
<td><em>The Lion King</em></td>
</tr>
<tr>
<td>1995</td>
<td><em>Toy Story</em></td>
</tr>
<tr>
<td>1996</td>
<td><em>The Hunchback of Notre Dame</em></td>
</tr>
<tr>
<td>1997</td>
<td><em>Hercules</em></td>
</tr>
<tr>
<td>1999</td>
<td><em>Tarzan, Toy Story 2</em></td>
</tr>
</tbody>
</table>
Year after year, they continued to release a new hit, which became an instant classic given the numbers (though nothing again reached *The Lion King* heights) and had strong enough brand awareness to spur made-for-video sequels (see later discussion, “Beyond an Ancillary Market: Emergence of Made-for-Video Market).

The success of Disney videos catapulted the head of Disney’s video division, Bill Mechanic, into executive stardom, and in the mid-1990s, he left Disney to become president of 20th Century Fox studios. In terms of animation, Mechanic never hit the peaks at Fox he experienced at Disney; acquiring Don Bluth studios and launching titles such as *Anastasia* helped Fox enter the lucrative market, but they failed to create a Disney-like brand engine from the genre. (Note: Fox eventually succeeded years later in building an animation brand via Blue Sky and its computer graphics hit franchise *Ice Age*.)

*The Emergence of and Transition to DVDs, including How Does A DVD Work; Early Stages of the DVD: Piracy Concerns, Parallel Imports and the Warners Factor; Influence of Computers: Cross-Platform Use of DVDs Speeds Adoption; Recordable DVDs and Perceived Threats from Copying and Downloading; Intermediate Formats (e.g., Laserdiscs and VCDs); and Revenue Sharing—Consequence of a Hybrid Market and Aid to DVD Adoption*

*[The following is reproduced from the Second Edition without modification]*

*The Emergence of and Transition to DVDs*

The video market has been nothing short of a cash flow godsend to studios and producers. After
the initial growth of rental and the consumer acceptance of the direct-to-retail sales model, the market took off again. The next phase was the development of the digital video disc (“DVD,” or in technical circles actually the digital versatile disc).

Technology had advanced such that it was possible to make a leap in video quality similar to the transition the record industry had gone through years before in converting from cassettes to compact discs (CDs). The CD quickly replaced the cassette when Phillips invented the digital encoding technology; the marketing thrust, and inevitably the driver in quick adoption, was that: (1) CDs were claimed to be indestructible (as opposed to cassettes, where the tape could get caught, jammed, or warped, permanently ruining the copy); (2) the sound quality emanating from digital encoding was a quantum leap forward from analog tape; and (3) CDs were smaller and therefore more portable than 12-inch vinyl records. While the random access convenience of just jumping from song to song on a CD was compelling (as opposed to fast-forwarding or rewinding), the notion of having a portable, near-perfect hiss-free and non-degradable crystal clear copy of music persuaded consumers. Sometimes, with technology, there truly is a better product, and CDs were a case in point.

I have digressed into the record business because the same forces were aligned against videocassettes. Different consortiums of motion picture studios, teamed with various consumer electronics manufacturers (e.g., Toshiba, Matsushita), pioneering DVD technology. They believed that the DVD offered the similar quantum leap from digital to analog quality that consumers had so overwhelmingly embraced in the record industry when moving from cassettes to CDs. As in the early days of the video-cassette, where format wars erupted between the Betamax and VHS formats, similar format wars took place on the DVD battlefront. Matsushita, the Japanese consumer electronics company (Panasonic brand) that had pioneered the VHS
format and acquired Universal Studios (only to later divest majority ownership in a sale to Seagrams) was supporting one standard, whereas Toshiba and Warners were supporting another.

An entire chapter could be written about these format wars, but suffice it to say that given the investment, historical fallout from prior format disputes, and the potential market size, the studios banded together to “adopt” a format.

How Does a DVD Work?

The underlying technology of DVDs is compression, or the ability to take a huge amount of data and store it efficiently. Accordingly, there is a level of randomness, since there is a direct relationship between the amount of data stored and the end quality; the more information, the better the resulting output quality. The inherent problem concerning compression for DVDs is that the amount of information that needs to be processed for a moving picture is staggering relative to an audio file. For a movie, each frame needs to be stored, including all the elements, ranging from backgrounds, to characters, to colors, shading, audio, etc.

The quantity of pixels that need to be reduced to digital 0s and 1s to compress a color film image was, in fact, too great to fit onto a disc, which was a driving technical hurdle preventing the invention of a disc or technology that could mimic a CD for film. The breakthrough came with the notion of looking at the differences between frames and only storing the differences; in this way, the amount of data that needed to be converted and stored was dramatically reduced. DVD compression actually “cheats” by omitting data. The compression digitizes and stores new elements, but in terms of going from frame to frame, only differences need to be kept. This efficiency trick, combined with massively greater storage/data capacity compared to a CD,
enabled compression of sufficient data to allow a typical film to fit on a single DVD disc.

Early Stages of the DVD: Piracy Concerns, Parallel Imports and the Warners Factor

At the Consumer Electronic Shows of the mid 1990s, gawkers and industry executives watching DVD demonstrations could intuitively grasp the leap in quality. DVD pictures were undoubtedly better, and the DVD offered the same type of ancillary upgrades to consumers that the CD had offered. Videotape often got stuck in machines, and DVDs eliminated those concerns, and were marketed with an aura of discs being “ultimate” and “permanent” (no one was talking about scratches, of course). Another user-friendly element was the elimination of having to rewind a tape. Rewinding a tape at the end of a movie is a universal nuisance, and some video rental stores even charged penalties if tapes were returned unwound. With a DVD, when the movie ended, you just hit a button—no rewinding, no hassle. As silly as it may sound, consumer market research regularly found the elimination of having to rewind as one of the most significant benefits of a DVD, which was statistically on par with the improved picture quality. Never overestimate the consumer!

A better mousetrap does not guarantee adoption, and in the case of the DVD, adoption was further hampered by studios’ reluctance to market and sell properties on the new format: virtually all major studio executives recognized the benefits of the DVD, but concerns over piracy and parallel imports were sufficient barriers to move slowly, if at all.

The following was the cost-benefit matrix of the time:

Costs/Negatives:
expenses to encourage consumer adoption

need to manage duplicate inventories (video and DVD)

piracy—DVDs held the potential of people making perfect digital copies

parallel imports (see later discussion)

Benefits:

better quality and durability

favorable user-friendly features (e.g., no rewind)

smaller packaging needs

less expensive manufacturing costs, therefore higher margins

ability to turnover library/catalog product by selling new format

Despite the apparent edge to the benefits, the inherent nature of the DVD as a perfect digital copy created significant anxiety at the studios. Intellectual property is the lifeblood of the system, and while video piracy was always a key concern, that concern heightened with digital copies. If just one person were able to make copies from a DVD, then, in theory, a pirate could have access to a digital master and illegally distribute perfect copies into the marketplace. This had the potential of undermining franchises, new releases, and entire studio libraries. The risk was simply too high, and until sufficient security was implemented most studios held back DVD releases of new titles (another form of windowing).

Adding to the problem was a concern about parallel imports. While it is commonplace to
theatrically release a major movie on the same date worldwide (day-and-date release, as discussed in Chapter 4), this was rare to nonexistent back in the mid-1990s when DVDs were first introduced to the market. Parallel imports means buying goods in one territory and importing them into another. For example, if a movie were released in May in the United States, it might be planned for a release in Europe or Asia at Christmas, the same time the DVD of the title would be coming out in the United States. There was nothing to prevent a retailer from buying quantities of the DVDs in the United States and importing them to the market where the movie was just releasing in the theaters, or worse, in advance of the theatrical release. What would happen if consumers could view (or worse, obtain) a perfect copy of the movie before it was even released in theaters? The potential of parallel imports had always existed, but, like piracy, the quality of digital copies heightened people’s fears. The box office revenues in international territories were growing consistently, and the theatrical release was too important a driver of the entire studio system to risk.

A key strategy to combat this practice and enable the broader introduction of DVDs was the implementation of regional encoding. This was a process devised by the studios where DVD machines and related DVD software would only work within specific territorial boundaries. For example, a chip would be placed in a machine telling it that it was a “European” encoded player, and this player would only play a disc encoded as European. If you put a disc from the United States (encoded as a United States disc) into a European player, the codes would not match and the disc would not play. The studios managed to gain acceptance from consumer electronics companies manufacturing players (likely helped by Matsushita’s relationship with Universal and Sony’s ownership of a Hollywood major), and all parties agreed to a worldwide map.

Interestingly, regional encoding is akin to a form of hardware-based digital rights
management (DRM), and was instituted to restrict how and where a consumer could play back a copy. Conceptually, DRM systems enable the same type of restrictions, but further open up a panoply of options down to managing how many times a product may be played on a specific machine (or overall). Regional encoding is still enforced today, and software bought in one territory will not play on a machine manufactured and sold in a different region. For those wanting to defeat the system, region-free players (which will play a disc regardless of which region it is encoded to) are available, but obviously for a premium price.

The net result of these fears, regarding piracy and the potential of undermining carefully orchestrated release windows, was that most studios were not releasing any titles on DVDs. Those studios that were entering the market were dabbling with older catalog titles where there was obviously no risk to current theatrical release. Sound familiar today? Again, history repeats itself, and the adoption of downloads or over-the-top releases of premium product and versions (e.g., HD versions) has been slowed by fears of pirating a perfect digital copy (just like the introduction of the DVD); accordingly, content owners often lead with catalog titles to mitigate the risk.

One exception to this initial reluctance to release a broad array of titles on DVD was Warner Bros. The president of Warner Home Video, Warren Lieberfarb, was among the earliest and most vocal proponents of DVD technology. Warners invested in a DVD authoring and replication facility, and simply believed that the DVD was such a superior technology that it was inevitable consumers would adopt the platform (not to mention the benefit of holding several related patents). For pioneering the technology, and championing its introduction against naysayers and those who wanted to delay launching, Warren Lieberfarb has been called “the father of DVD.” Even within an incredibly competitive industry, people acknowledge Warners’
leadership position as the catalyst for the transition to DVD from video. Most people forget, or were oblivious to, the significant risks to protection and window management of vital intellectual property assets that stalled and almost prevented the introduction of DVDs.

Influence of Computers: Cross-Platform Use of DVDs Speeds Adoption

One significant factor in the acceleration of DVD penetration was the crossover between consumer electronics players and computers. DVDs had an exponential increase in storage capacity versus floppy discs and CDs. (Note: A standard DVD holding a two-hour movie plus customary ancillary value-added materials (VAM) has roughly 9 GB of content, while Blu-ray boasts an increase to 50 GB.)

As DVD drives slowly replaced other storage mediums on PCs, it was only a matter of time for convergence to take place. With a common software medium, consumers could store data, download pictures and music, and watch movies all with DVDs. Further, this convergence dovetailed with the increased penetration of laptop computers. It was now possible to bring a DVD of a movie on your laptop for a plane ride, jumping between spreadsheets and entertainment. History would repeat itself once again, with integrated systems used to drive adoption—Sony included Blu-ray players with its next-generation PlayStation 3 console system, hoping the consumer electronics product (this time a games system rather than a PC) would help drive adoption.

Recordable DVDs and Perceived Threats from Copying and Downloading
Once it became clear that DVDs were the medium of the future and would replace VHS cassettes, the next obstacle was the ability to record. For the same reasons that slowed the introduction of the DVD, piracy and economic fears tied to the ability to make digital copies, a recordable feature was delayed in the marketplace. It was one thing to allow a DVD, but the dangers ultimately seemed manageable without the ability of the consumer to burn copies of movies. As an accommodation to the concerns of the studios, the major consumer electronics manufacturers launched play-only DVD machines; when compared to the complexity of regional encoding, this was a relatively easy measure to assuage the software distributors.

Over time, however, pressures for recordable players overwhelmed this protectionist direction; moreover, the consumer electronics industry was not in a position to stop the computer manufacturers from deploying recordable drives. Memory and storage is the mantra of the personal computer industry, and computer manufacturers were inclined to encourage data storage rather than impede it. Whether music or digital camera/pictures, the new applications were growing at breakneck speed. It was unrealistic to expect that DVDs could record everything but visual entertainment software.

Giving the studios solace in terms of DVD burners becoming a standard accessory was the fact that movies are not easy to copy. The amount of data compressed is staggering, and it is cumbersome and complicated to copy a movie relative to a business file or music CD. Moreover, anti-copying mechanisms are encoded on films preventing the simple copying of a movie on DVD. The larger fear is the Internet, and while lengthy download times for movies (hours rather than minutes) seemed initially to pose a significant enough hurdle to give distributors comfort, technology again advanced and P2P file sharing exposed the underlying fear that had loomed with digital copies since the advent of DVDs.
At first, digital rights management systems (and the lure of new revenue streams) seemed to have progressed quickly enough to temper those fears and promise significant and ongoing roadblocks to the easy pirating of copies; however, it was this backdrop that caused the studios to take a strong stand in the Grokster case when the ability of P2P services demonstrated facility and scale for making pirate copies. This created the biggest challenge to the industry since the enabling Sony v. Universal case roughly 20 years before. (Note: See Chapter 2 for discussion of file sharing, P2P downloading technology, and the Grokster case in terms of the relationship to piracy and digital downloading.)

Intermediate Formats: Laserdiscs and VCDs

Finally, it is worth mentioning that, as in most areas of technology, there were intermediate steps between VHS and DVD adoption. Some may remember the laserdisc, which was dominated by companies such as Pioneer. Laserdiscs were about the size of an old phonographic record and had better clarity and durability than standard VHS tape; they were, accordingly, priced higher, and the early adopter videophiles built up collections of laserdiscs. Laserdiscs were still, however, based on analog technology and were ultimately doomed with the advent of the digital age. Consumers that always wanted the best available technology/presentation of the time built up collections, but the life of laserdiscs was comparatively short and the penetration of the hardware players relatively limited when compared with the mass-market adoption of both VHS and DVD and then Blu-ray.

Similarly, in Asia, and in particular Southeast Asia, a market grew up for video CDs (VCDs). These are CD size and look like DVDs, but simply have inferior compression and memory, and
accordingly inferior picture quality. VCD distribution grew quickly in markets rife with piracy, and a consumer could usually find a low-quality and unauthorized version of virtually all studio blockbusters on VCD in the local markets. Because penetration grew quickly, it took some time for DVDs to supplant this market. However, with VCDs and laserdiscs both intermediate and inferior products to DVDs, these formats began to quickly disappear; in fact, I suspect most readers of this book will never have heard of them.

Revenue Sharing—Consequence of a Hybrid Market and Aid to DVD Adoption

Revenue-sharing arrangements took off in the late 1990s. This was a scheme where the major studios gave the major video rental chains, such as Blockbuster and Hollywood Video, their titles on a consignment basis. Rather than charge $29–40 for a title, the studios deferred the upfront revenue in favor of a split of rental income. Although deals differed, it was reputed that a rule of thumb granted the studios 60 percent of the revenue from rental transactions; moreover, once a title had been past its peak release period, excess inventory was sold in-store ($5–15 range), with the proceeds shared between the distributor and rental chain.

Some have theorized that the introduction of revenue sharing was a gambit to increase DVD penetration, as the studios encouraged the shift away from VHS (in fact, some former video division heads have alleged just this tactic).

Once DVD penetration had hit mass-market levels, prices started coming down for both players and new release titles and revenue-sharing schemes waned. The Hollywood Reporter cited these factors and attributed the decline in revenue sharing to the increase of the consumer purchase market at the expense of the video rental store:
Once DVD hardware market penetration reached about 50 million players in U.S. households by 2002, WHV and other major Hollywood studios began ratcheting down their rental revenue-sharing participation, while aggressively discounting the wholesale and retail price of movies on DVD. The new popularity of DVD, combined with low-priced hit new releases and classic catalog product, energized consumer spending on home videos, resulting in a national average household buy rate of 15 DVDs a year at an estimated price point of $19 or more each. That consumer action translated into triple-digit revenue gains at the studios. At the same time, the paradigm shift had reduced in-store foot traffic at video rental outlets nationwide, taking a huge bite out of gross consumer spending on movie rentals.  

Examples of “video sequels” or spin-offs during this video renaissance included:

[The following is reproduced from the Second Edition without modification]

- *Aladdin and the King of Thieves* (1996)
- *Pocahontas II: Journey to a New World* (1998)
- *The Lion King 2: Simba’s Pride* (1998)
- *Lady and the Tramp 2: Scamp’s Adventure* (2001)
■ Tarzan & Jane (2002)
■ The Lion King 1½ (2004)
■ Mulan II (2005)
■ Tarzan II (2005)
■ The Fox and the Hound 2 (2006)³⁴

Fox jumped on the bandwagon with titles such as FernGully 2: The Magical Rescue, as did Paramount, leveraging well-known characters and brands, such as Charlotte’s Web 2: Wilbur’s Great Adventure. Independents that had strong children’s properties expanded their brand. A prime example was Lyric Studios franchise Barney; in addition to taking television episodes to video, live Barney concerts were perfect fare to release on DVD.

Perhaps the most successful example of a made-for-video property came from Universal Studios. Universal had theatrically released a film called The Land Before Time, executive produced by George Lucas and Steven Spielberg, to moderate success. Recognizing the inherent appeal of the characters, children’s love of dinosaurs, and the franchise potential, Universal invested in video sequels. The Land Before Time franchise became so successful, and the potential for other made-for-videos was considered so high, that Universal created a new division called Universal Family and Home Entertainment. Headed by the former president of Universal’s video division, Louis Feola, Universal produced a series of animated (e.g., Balto: Wolf Quest) and live-action (e.g., Beethoven’s 3rd, Beethoven’s 4th, Beethoven’s 5th, Slap Shot 2: Breaking the Ice) properties under this banner. (Note: More current made-for-video titles
include *The Scorpion King 2* and the *American Pie Presents* sequels (*Band Camp, The Naked Mile, Beta House*), the latter of which are estimated to have sold 1–2 million copies each.35 *The Land Before Time* property spawned more than 10 sequels, making it one of the most prolific and successful children’s franchises in the marketplace.

**Next-Generation DVDs: Blu-Ray versus HD-DVD—Format War Redux**

[The following is reproduced from the Second Edition without modification]

In 2006, two new competing high-definition DVD systems were introduced pitting rival Japanese consumer electronics manufacturers against each other (again). Blu-ray, developed by Sony, and HD-DVD, developed by Toshiba, were pitted against each other, offering high-definition images (1080) and a remarkable amount of storage capacity (25–50 GB). Different partners lined up behind each, with Microsoft in the HD-DVD camp and a greater number of Hollywood studios (e.g., Disney and Fox) initially jumping on the Blu-ray bandwagon. Adoption was slow, however, as no parties wanted to be beholden to a format that might not win, the initial price points for players were high ($350+), and consumers were not convinced that the quality differential from standard DVDs warranted a pricey upgrade. Unlike earlier format wars, both sides tried to speed adoption by integrating the new players into other hardware: Sony including a Blu-ray player in each new PlayStation 3 game console, while Toshiba bundled its HD-DVD drives into notebook computers and Xbox 360 game systems.

It was a déjà vu scenario, with full-scale war between two major Japanese consumer electronics companies, billions of dollars potentially at stake, and the consumer caught in the middle, waiting out the format winner. With both sides having sold approximately 1 million units
by the end of 2007, there seemed no clear winner in sight, and headlines abounded. This one was seen in the *International Herald Tribune* on New Year’s Day 2008, just days before the annual mass gathering at the consumer electronics show in Las Vegas: “The Format Wars: Titans Stuck in a Stalemate—Despite Months of Tussling, No Clear Winner Has Emerged in the Battle Between Blu-ray and HD-DVD.”

I was even part of the prior lobbying efforts, with studio partners and other vested parties alike courting Lucasfilm for an endorsement. What do you do when you have different franchises with different studios, and you do not know who may distribute your next film or TV series?

Then, suddenly everything changed and the battle was literally over. In February 2008, Warner Bros., the pioneer in traditional DVD, had been on the fence and then came out in favor of Blu-ray; within the same week or so, Walmart came out and announced it would no longer stock HD-DVDs or HD-DVD players. With the market share leader for DVD sales at retail and Warners both coming out in favor of Bluray, it shocked the market, and Toshiba pulled out. No doubt, there was growing fear that delay could doom the entire industry, and if all the studios did not start lining up behind a common format, the danger existed that high definition would miss its window and be bypassed entirely by the growing download markets, akin to CDs being replaced by digital files. In a sense, as typical with the introduction of new technology in the media, one battle had ended and another was just beginning.

Finally, one feature of Blu-ray put the physical media on a path to embrace the Internet—perhaps consciously designed to ensure a place working within the new Internet world rather than having to simply compete against it. “Blu-ray live” enables an interactive feature that allows viewers to simultaneously watch a film along with its director, seeing commentary and chat live while the movie is playing. Among the first tests of this component was an invitation to watch
The Dark Knight along with its director, Christopher Nolan, and reportedly up to 100,000 people were supposed to be able to watch along together.

Blu-Ray to the Rescue?

Blu-ray is providing industry optimism after years of decline in the video industry—growing by roughly 20 percent in 2011, cresting $2 billion for the first time, and then seeing a 13 percent sales increase through the first half of 2012, Blu-ray sales are now material and mass market. Part of the growth has been organic, but industry insiders acknowledge that Avatar helped fuel the growth, with Blu-ray sales of the film reaching 11 million units worldwide. With this market penetration, by the end of the third quarter, 2011 revenues from Blu-ray sales for the first time surpassed revenues from rental kiosks ($423 million for Q3 2011 from Blu-ray versus approximately $414 million from kiosk rentals). This was extremely good news for the video industry, because margins tend to be higher from the sale of retail products than from rentals, and the only material growth in the prior few years had been from low-cost rentals, including, most importantly, Netflix and Redbox (see below for further discussion). Despite all this positive spin, it is important to put Blu-ray in context, as the increase in Blu-ray has been more than offset in declines in traditional DVD sales.

Peaking of the DVD curve and its decline, and how the DVD sales cycle became compressed with the substantial majority of retail sales (titles to buy) taking place in the first couple of weeks after availability—mimicking the trend to frontload sales at the box office.

[The following is reproduced from the Second Edition without modification]
By the late 1990s, it was clear that DVDs were the format of the future, and in the ensuing years literally exploded. Growing from less than 10 percent in 1999, by the end of 2006 penetration exceeded 80 percent and had bypassed VCR penetration. By 2003, annual DVD rental revenues exceeded VHS revenues, and by 2005 the number of VHS units of a major title relative to DVD units was negligible. In fact, by 2005 many titles, such as *Star Wars: Episode III – Revenge of the Sith*, were released only on DVD.

Figure 5.2 Complexity of DVD/Blu-ray Supply Chain

With the growth of DVD, the balance between rental and sell-through started to shift dramatically toward sell-through. The durability and quality of DVDs, together with the ability
to include special features (see discussion regarding VAM), made them ideal retail items, as well as perfect gifts. All of a sudden, it was not just Disney selling huge numbers of children’s videos, but key titles from all studios were selling in the millions. And for children’s properties, the numbers simply kept growing. *Shrek*, released in 2001, reportedly sold 2.5 million units in its first three days en route to selling upwards of 20–30 million units worldwide, as did Disney–Pixar’s *Finding Nemo*.

Depending on whose statistics one believes, the DVD/video market peaked somewhere between 2004 and 2006, and by the end of 2005 it was evident that the market was entering into a phase of decline, both on a by-title basis as well as overall. Given the size and importance of the home entertainment market in the media sector, this was mass-market news, as *USA Today* highlighted: “For the first time in home video’s nearly 30-year history, sales and rentals slipped in 2005 as slowing growth of DVDs couldn’t overcome falling prices and a dying VHS market.”

While, historically, home video revenue from most blockbusters equaled or surpassed that of their box office take, the trend seemed to have peaked. Describing the drop in conversion rate—the ratio of video sales to theatrical—*Variety* reported that the theatrical gross exceeded the DVD revenues of films such as *Batman Begins* and *War of the Worlds* (e.g., *Batman Begins* video revenues $170 million versus $205 million theatrical gross). There has been a continuing decline in the DVD market ever since this peak and, as noted and demonstrated by comparing 2nd edition Figures 1.5 and 5.1 (studio revenue breakdown in 2007 vs. 2012), the impact has been a steep fall in terms of the percentage of the overall studio revenue pie attributable to the video market (down to 30.4 percent from 48.3 percent). 2008 typifies the dramatic nature of the falloff, when there was a precipitous drop in new release volumes, estimated to be down close to 20
percent. Illustrating the severity of the decline on a by-title basis over almost a decade, 2nd Edition Table 5.3 lists the top-selling DVDs for 2003 versus 2008 and 2011 in the United States.

Given the overall importance of DVDs to the studio revenue base and ecosystem, this pace of decline continues to set off alarm bells; the cause can no longer be attributed solely to a recessionary climate, and the shift is putting even more emphasis on the future of electronic sell-through, subscription streaming, and other new consumption patterns in the digital space.

Compressed Sales Cycle

The other factor impacting the market maturation was an increasingly compressed sales cycle. This has been accentuated by the flood of additional product trying to take advantage of DVD dollars. Whereas only a few years earlier shelf space competition was between different hit movies, the largest growth sector became TV product and box sets; with a glut of new and catalog TV releases, together with made-for-DVD product, competition became fiercer, shelf space turned over more quickly, and sales cycles compressed. In a sense, the DVD retail cycle was beginning to mimic the box office, with revenues more front-loaded by the year, and films earning the majority of their video revenues within the first two weeks of release. In fact, most studios acknowledge that the majority of sales on a title now come in this short period. The Wall Street Journal highlighted this shift: “a typical DVD release would rack up about one third of its total sales during the first week of release; the figure was even lower for animated movies, which tended to have longer legs. DVD sales would then steadily mount over weeks or months. But these days, DVD releases are generating a huge percentage of their total sales—typically over 50 percent and in some cases, up to 70 percent—in the first week.”
### 2nd Edition Table 5.3 Top Five DVDs of 2003, 2008, and 2011

<table>
<thead>
<tr>
<th>Studio</th>
<th>Title</th>
<th>Date</th>
<th>Units</th>
</tr>
</thead>
<tbody>
<tr>
<td>Disney</td>
<td>Finding Nemo</td>
<td>2003</td>
<td>26,000</td>
</tr>
<tr>
<td>New Line</td>
<td>The Lord of The Rings: The Two Towers</td>
<td>2003</td>
<td>21,050</td>
</tr>
<tr>
<td>Disney</td>
<td>Pirates of the Caribbean: Curse of the Black Pearl</td>
<td>2003</td>
<td>19,450</td>
</tr>
<tr>
<td>Warner Bros.</td>
<td>The Matrix Reloaded</td>
<td>2003</td>
<td>15,520</td>
</tr>
<tr>
<td>Universal</td>
<td>Bruce Almighty</td>
<td>2003</td>
<td>12,650</td>
</tr>
<tr>
<td>Warner Bros.</td>
<td>The Dark Knight</td>
<td>2008</td>
<td>12,385</td>
</tr>
<tr>
<td>Paramount</td>
<td>Iron Man</td>
<td>2008</td>
<td>11,375</td>
</tr>
<tr>
<td>Fox</td>
<td>Alvin and the Chipmunks</td>
<td>2008</td>
<td>10,560</td>
</tr>
<tr>
<td>Warner Bros.</td>
<td>I Am Legend</td>
<td>2008</td>
<td>10,125</td>
</tr>
<tr>
<td>DreamWorks</td>
<td>Kung Fu Panda</td>
<td>2008</td>
<td>9,750</td>
</tr>
<tr>
<td>Animation</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Disney</td>
<td>Tangled</td>
<td>2011</td>
<td>7,635</td>
</tr>
<tr>
<td>Disney</td>
<td>Cars 2</td>
<td>2011</td>
<td>5,340</td>
</tr>
<tr>
<td>Universal</td>
<td>Bridesmaids</td>
<td>2011</td>
<td>4,695</td>
</tr>
</tbody>
</table>
This trend developed outside the pressures of new media, making the issue of how to window downloads that much more complicated. The DVD cash cow was set for a reversal of fortune, and no studio wanted to accelerate that trend. Unless downloads could be proven to add incremental value, let alone not cannibalize DVD, there was little impetus to experiment with key new releases.

*Retailer-Specific Implementation and how the practice of loss leading product developed to drive store traffic*

[The following is reproduced from the Second Edition without modification]

Implementation of marketing programs is tailored at the retail level, typically tiered to the anticipated volume. In all markets, it is common to have a key account list, which will vary by studio and type of product (e.g., specialist account), but mainstream releases would typically include the following U.S. retailers (excluding wholesalers): Amazon, Best Buy, Walmart, Target, BJ’s Wholesale Club, Borders, Circuit City, Costco, and Hollywood Video. (Note: A number of those outlets, including Borders, Circuit City, and Hollywood Video, have since filed for bankruptcy—a telling sign of the overall retail marketplace.) Depending on the title and studio, a select few top accounts, such as Walmart, Target, Best Buy, and Amazon, could easily account for over 60 percent of the total volume.
For the top-volume accounts, and on certain key new release titles, it may make sense to customize programs. Types of programs can obviously vary widely, but examples of specialized focus may entail:

- special product placement, such as guarantees of being positioned near the checkout register
- unique creative campaigns for posters, or buttons for staff
- rebate programs tied to individual purchases, such as point-of-sale rebates, or overall volumes
- discounts tied to sale of other purchases
- discounts tied to store gift cards
- customized packaging
- customized value-added offers (e.g., bundled merchandising, such as an action figure)
- special merchandisers, such as product towers
- special placement in circulars or flyers
- consumer prizes/sweepstakes

There is no limit to the creativity of a campaign.

Deals and programs will naturally depend on both the leverage of the title and market clout of the retailer. In many cases, it is the retailer, with the premium shelf space as the interface to the consumer, that can dictate terms. In fact, retailers with large traffic volume sometimes charge placement fees, such as to stock a video title in the end cap at the checkout lanes (e.g., charging a per-unit fee, and in extreme cases even holding a mini-auction and granting the space to the highest bidder).
Loss-Leading Product and Fostering Consistent Consumer Pricing

Another product of leverage is loss-leading a product. For a big enough title, it is not unusual for a retailer to deeply discount the title for a limited period if it is likely the special price offer will bring customers into the store. Many of the top accounts obviously carry a wide range of product, and the likelihood of additional sales if they can attract a customer into the store is high enough that sacrificing margin on a video title pays off. In extreme cases, the store is even willing to lose money on a title.

Although this sounds like a good deal to the video distributor (you can hear the video salesman gloating, “they want my product so badly they’re willing to lose money!”), the trick to successful sales is managing the overall market, and one account can cause havoc. If a particular retailer dramatically undercuts its competitors, such that traffic is truly taken away from its competitors, then for the distributor the increased volume at that one chain better make up the difference. Otherwise, the distributor will be looking at lots of disgruntled customers who may want to return the product or may not be as accommodating on their next title or campaign. Remember, the wholesale pricing will have been relatively consistent, so a sale from Store X is relatively fungible to a sale from Store Y, and success is driven by making retail sales successful across the entire channel. No distributor wants to spend millions of dollars on an overall advertising campaign to support retail only to have one or two retailers undermine the overall effectiveness.

It is illegal to set onward retail pricing, and once a video is sold the buyer who bought in order to resell is free to set its price (U.S. first-sale doctrine, antitrust, price fixing); accordingly,
a video distributor cannot prevent a specific retail account from pricing as they choose. A retailer could elect to give the DVD away for free, regardless of the price it paid for the unit to the distributor. If they want to lose money, that is their prerogative.

There is one accepted practice, however, that buffers this risk: establish minimum advertised price (MAP). A distributor is not obligated to financially support the retail marketing campaign, and there are certain quid pro quos established for committing to cooperative advertising and market development fund dollars. To be eligible for MAP contributions, a distributor may dictate that the retailer may not advertise the product for a price below $X. With this arrangement, the video retailer ensures a relatively consistent price band, yet the retailer maintains flexibility for the ultimate on-shelf price.

When MAP policies are set, they are almost always limited in time, such that on expiry the retailer is free to set and advertise pricing at will. In some cases, a distributor may strategically set MAP expiry to dovetail with a specific anticipated time of re-promotion or anticipated markdowns (especially if dealing with seasonal dates).

**Netflix’s Qwikster Debacle**

*[The following is reproduced from the Second Edition without modification]*

In less than a month’s time in September 2011, Netflix announced and then abandoned a new brand, Qwikster, which will live on in business school case study lore—of what not to do. In the summer of 2011, as its stock hit an all-time high, Netflix announced: (1) that it was significantly increasing the price of its service that allowed customers to obtain DVDs through the mail and access unlimited streaming of titles online: instead of only $9.99 per month, customers would
have to choose between now paying $15.98 for the bundled offering, or pay $7.99 per month for streaming access only; and (2) that Qwikster would be the new name/brand for its streaming-only service. The Economist, in an article titled “Netflix Messes Up,” described how Netflix, fearing “being left behind by technological change, like AOL with its dial-up service,” saw its future in streaming, but failed to anticipate the customer hostility that led to jamming the company’s switchboard with complaints, being deluged with hostile comments on its Facebook page, and causing the stock to plummet: “The company’s reputation for top-notch customer service has been tarnished . . . Netflix has made a tactical error and treated its customers shabbily. It has also jumped too hastily into the future—as if Renault were to declare that electric cars are the future and rename its petrol car division Qwikmobile.”

The Wall Street Journal, citing famous branding mistakes such as Coca-Cola’s failed introduction of “New Coke,” stated: “Netflix joins a list of companies with embarrassing flip-flops,” and graphically plotted the failed introduction against the company’s falling stock price (see Figure 5.4). (Note: As discussed later, Netflix quickly rebounded and its streaming business grew to dominate, if not define, the SVOD business; see next section and also Chapter 7).
There is no doubt that given the importance of DVD revenues, there has been pressure to tinker with the window. In analyzing the tug of war between competing media, Business Week
summarized:

To capture that DVD gold, Hollywood has for years made its flicks available to TV viewers only through a carefully structured system of “windows.” DVD retailers waited six months after the theater premiere; cable’s and satellite’s video-on-demand (VOD) got the film 90 days after that, and HBO and other pay TV services six months following VOD. But the windows have been slowly closing, and studios now ship DVDs to market sooner than ever before—on average, in 137 days (versus 200 days in 1998), according to DVD Release Report . . . 52

While this may sound dramatic, I would argue that the shrinking of the window has been merely iterative; in fact, and perhaps not surprisingly given the continued importance of both the theatrical and video markets, the window for video release, while accelerating, has stayed relatively static for several years. Window protection is so important for theatrical releases that the cinema chains exert extreme pressure, and will even in extreme cases boycott studios that test closing the gap by accelerating a DVD release date too close to the theatrical release.53 The movie cinema trade association National Association of Theater Owners (NATO) goes so far as to track the window/gap studio by studio, down to average days post release and “announcement” dates. Table 5.4 is a schedule of the video release window by year, as reported by NATO.

While there is significant experimentation with download/electronic sell-through and VOD windows (as discussed in Chapter 7), the DVD window, even if narrowing a bit, seems to remain a relatively stable fulcrum around which manifestations of physical and electronic video sales
and rentals are trying to balance. As discussed above, there are changes in holdbacks to lower priced rental options, such as in the case of Netflix and Redbox, but this is generally fine-tuning around the broader DVD window; as services morph from being perceived as video rental to being more akin to pay TV, however, then the windows will shift more fundamentally—as is already starting to happen, including the introduction of a new Digital HD window.

I asked Mike Dunn, president of 20th Century Fox Home Entertainment, what he thought about the video window relative to expanding digital options, and he confirmed the continuing importance of physical media while highlighting the need to provide alternatives in order to fulfill the consumer’s demand for digital access across a range of devices:

Digital is redefining home entertainment, with consumers’ changing habits influencing the way TV and movies are delivered and enjoyed across a range of screens. While physical media remains a key part of the industry, with Blu-ray flattering large-screen, Wi-Fi-enabled HD and 3D televisions in the living room, the need to meet consumer demand for access across all their connected devices has fostered new momentum and innovation for digital downloads and electronic sell-through models.

2nd Edition Table 5.4 Average Video Release Window

<table>
<thead>
<tr>
<th>Year</th>
<th>Average Video Release Window</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998</td>
<td>5 months, 22 days</td>
</tr>
<tr>
<td>1999</td>
<td>5 months, 18 days</td>
</tr>
<tr>
<td>2000</td>
<td>5 months, 16 days</td>
</tr>
<tr>
<td>Year</td>
<td>Duration</td>
</tr>
<tr>
<td>------</td>
<td>------------------</td>
</tr>
<tr>
<td>2001</td>
<td>5 months, 12 days</td>
</tr>
<tr>
<td>2002</td>
<td>5 months, 8 days</td>
</tr>
<tr>
<td>2003</td>
<td>4 months, 27 days</td>
</tr>
<tr>
<td>2004</td>
<td>4 months, 20 days</td>
</tr>
<tr>
<td>2005</td>
<td>4 months, 18 days</td>
</tr>
<tr>
<td>2006</td>
<td>4 months, 11 days</td>
</tr>
<tr>
<td>2007</td>
<td>4 months, 19 days</td>
</tr>
<tr>
<td>2008</td>
<td>4 months, 10 days</td>
</tr>
<tr>
<td>2009</td>
<td>4 months, 11 days</td>
</tr>
<tr>
<td>2010</td>
<td>4 months, 12 days</td>
</tr>
<tr>
<td>2011</td>
<td>4 months, 5 days</td>
</tr>
<tr>
<td>2012</td>
<td>3 months, 29 days</td>
</tr>
</tbody>
</table>


At Fox Home Entertainment, we understood the potential for Bluray to demonstrate for consumers what was possible in digital. We heighten the relationship fans have with their favorite entertainment by making available new content through downloads and second-screen engagements. Not only could fans view TV shows and movies in stunning visual quality, but they could receive new narratives, unseen footage, and commentaries, as well as purchase in real time the clothes and accessories worn by their favorite characters. This willingness for consumers to engage and embrace digital through Blu-ray, along with the evolution of portable devices on which content is enjoyed, seeded consumer interest and drove our leadership in new
digital delivery models.

Our digital strategy supports fostering easy, affordable, and accessible ways for consumers to access their entertainment anytime and enjoy it across all of their devices. This approach is also leading to new business models, while fostering the evolution of UltraViolet and other ways for consumers to amass digital collections. In 2012, as an example, we launched Digital HD, which redefines electronic sell-through and combines for unique benefits: early access, affordable pricing, cloud storage, and availability across multiple devices. The Ridley Scott epic *Prometheus* was our first Digital HD title, and was available three weeks ahead of its physical media launch into the home market. With a single purchase, consumers can enjoy the movie on any screen in the highest quality possible. The success of the release, and others that have followed, demonstrate the opportunities that come with embracing what’s next and appealing to what consumers say they want: convenience for our digital lifestyles.

**Physical Disc Inventory Management and Impact on (Retail) Pricing and Profits**

The video business became a typical consumer retail business, subject to all the pitfalls and challenges of stock management. The following is an in-depth discussion of the tactics and issues that were historically involved (including issues involving initial shipment, impact of different SKUs, replenishment and fulfillment logistics, return policies and management, return reserves, price protection, point of sale rebates, use of moratoriums, risks of price erosion, parallels to sales of physical video games, and the general impact of returns on pricing and profits).

*The following has been reproduced from the second edition without modification*
Returns and Stock Management

Probably the biggest single issue impacting the release of a title into the sell-through market is managing inventory. Rental units are generally firm sales, and when a rental chain decides it is overstocked or inventory has reached obsolescence, it can either destroy the units or sell them. Sell-through units/DVDs are, however, no different than any other consumer product, and excess stock is most often subject to return.

There are multiple steps in inventory management, and I will briefly touch on the life-cycle sequence in which they occur: (1) initial shipments; (2) replenishment; (3) returns; (4) price reductions and price protection; and (5) catalog management. While managing this process has been the focus of video divisions for years, a move to digital distribution (whether streaming or EST downloads) eliminates the need to manage inventory, as well as the risk associated with insufficient or excess stock. If electronic/digital distribution were therefore wholly substitutional for physical discs, there would be no reluctance, and in fact exuberance, in shedding the burden of managing physical stock. It is because we are not yet at this point, though, and because video still remains a very significant revenue source (not to mention the impact these factors have had on the evolution of the market), that I will discuss them in detail below.

Parallels in Games Market [Non-mobile]

Before addressing these elements, though, I want to briefly highlight that the same issues apply to most packaged-goods entertainment, and especially to the video-game industry. The implications of the shift to digital distribution in the games market is heightened due to an
advantage not found with video—not only can distributors of product made for the major console platforms (Nintendo Wii, Microsoft Xbox, Sony PlayStation) eliminate inventory risk if games are downloaded via online networks such as Xbox Live Arcade, but game distributors also have the ability to update games with patches, new levels, and character add-ons. Moreover, these same online distribution platforms enable networked playing and other interactive features, providing further additional benefits to transitioning.

Similar to the video scenario, these benefits do not come challenge-free, as digital distribution is simultaneously enabling new competitive download options. The games industry is watching carefully the growth of fully online portals such as Steam, which bypass the console platforms entirely and allow 100 percent digital PC access; there is less risk to the ecosystem at the moment with such outlets, however, as the content providers must first port the games for play on these platforms. The combination of being able to control whether to port games to non-console digital platforms, coupled with the generally inferior user experience versus utilizing controllers (though you can now buy plug-in joysticks, etc.), ensures, at least for the time being, that these online systems remain ancillary. The major console manufacturers who dominate the games market, having created a captive vertically integrated end-to-end ecosystem, can accordingly limit downstream applications via licenses and benefit from the fact that, unlike videos, games can be updated and expanded via digital downloads. This measure of control enables the same players to manage the expansion and integration of new download experiences—as discussed in Chapter 8, the threats faced by the old guard are more from social games, which leverage digital distribution and “freemium” business models. Although these new types of games may create some pricing pressure, it is generally considered a different market, appealing to a different and expanded user base (“casual” games versus “core” games), thus
holding more potential for market expansion than cannibalization. The end result is generally
benefitting the games business, and the longer-term challenge will be how producers can
maintain high product price points (pricing has always been artificially high, given the need to
pay manufacturing fees to the console owners that keep manufacturing captive under the guise of
proprietary patented systems and the need to recoup costs of developing upgraded next-
generation systems). Digital distribution with games, as with videos, eliminates the physical disc
costs, and it is harder to justify a high per-unit cost, even if that is tied to a licensing and system-
access model. Accordingly, the games business, which has always benefitted from high pricing
and margins, will benefit similarly from reduced distribution costs, but those same pressures will
ultimately force lower pricing, with the danger that margins will fall as well.

Initial Shipment

This is by far the most important step, because miscalculations on initial placement will plague
the title’s performance all the way downstream. It is debatable whether it is worse to over-ship or
under-ship, but if demand outstrips supply and a title has been under-shipped, there are really
only a couple of issues to address.

First, the obvious consequence is lost sales, and opportunity costs are always the hardest
element to accurately forecast. If the under-shipment is recognized early, by utilizing an efficient
supply chain (see later discussion) it is still feasible to capitalize on demand. However, because
marketing campaigns are designed to create intense demand on release, absent a honed and
tightly managed supply chain it is obviously difficult to reach fully substitutional sales outside
the window of coordinated advertising and retail marketing/focus.
Second, the distributor needs to confirm how feasible it is to quickly replenish inventory and mitigate lost sales. In the mid to late 1990s, this would have been difficult, but as the market has matured, so has the replication and distribution system. Today, single plants may be able to produce 1 million discs per day and deliver them nationwide to out-of-stock retailers within the week—full replenishment may not be possible literally overnight, but it is feasible in a matter of days. Again, days count when dealing with a coordinated marketing campaign; the consequences of being out of stock and replenishing late include: (1) losing retail placement position; (2) losing retail focus; (3) selling against a new competitive title; and (4) missing key sales days such as weekends or seasonal-specific dates.

If, in contrast, the initial shipment has glutted the market and it turns out the distributor has materially over-shipped, there is likely to be pressure to take returns. This leads to complex management challenges, including price-protection decisions, as discussed later. Moreover, overstating revenues and having to reverse out-earnings due to returns is a serious problem and (as also discussed later) has been responsible for significant downturns in the stock prices of companies who miss their targets.

Replenishment, Fulfilment, and Logistics

The sophistication of the market largely dictates how replenishment works. In the United States, the video arms of the studios and supply chains of the replicators and distributors are models of efficiency. On a major release, a studio has visibility into its large direct customers to the extent that it can check sales periodically during the day. The inventory and sell-through numbers are constantly updated, and it is possible to see how a title is progressing on release early in the week.
and top up SKUs as necessary for the weekend. Replicators able to churn out hundreds of thousands of units per day (if not more) then further decide how many units to build at which stage of production, balancing finished-goods inventory versus elements needed for a quick turnaround on the assembly line.

As the sell-through business matured, the duplicators recognized that they could fulfill additional distribution functions. Not only could they make the physical good, but they could handle the logistics of sorting SKUs, packing the product, and shipping the product. This step is frequently referred to as “pick, pack, and ship,” and involves the logistics of everything in the chain, from completion of the physical good to delivering the good to the retailer. It may seem simple here, but the process of sorting inventory for delivery to retailers is a mechanized art.

The management of the backroom logistics does not stop there, however. The replicator has now taken on the task of processing returns, repurposing stock, invoicing the client/retailer, processing related credits, and even handling some collections. Basically, the entire chain, from manufacturing, to delivery, to payment, can be outsourced, leaving the intellectual property owner to focus on marketing the product and setting customer-specific terms.

The less sophisticated the retail market, the harder it is to replenish efficiently—the replicators have the systems, but without the retail systems to report offtake efficiently, the distributor is left to place all its product up front. Otherwise, the distributor risks out of stocks without the ability to replenish; this is not a viable option when the product has a short shelf life, driven by a burst of front-loaded advertising to drive consumers to purchase in a relatively short window. As discussed previously, the decay curves for video sales are becoming steeper, with an ever-increasing percentage of total sales on a unit in the first couple of weeks of release. Again, this correlates to increased competition and the fight for shelf space, with most displays rotating
out on a regular weekly or biweekly basis and restocked with the “new title of the week.”

No matter how efficient the supply chain and replenishment logistics, there is no guarantee of sales and always a risk of over- or under-stocks. While the risk is not nearly of the scale as on the theatrical release (as theatrical results convert the product from a nobody-knows experience good to a property that can be more accurately forecast for subsequent market sales—conversion rates), significant risks, even if more bounded, still exist. Because of the marketing profile, the trend has been to oversupply to ensure against out of stocks, as well as secure optimum store display. While every distributor knows they need to ship in more than 1 million units to sell-through 1 million, the art is to narrow the gap as much as possible without jeopardizing sales—the greater the efficiency in this stock management, the greater the margins and profits.

Returns

Historically, distributors have negotiated returns provisions with retailers that tend to be account-specific. A customary provision, for example, may be that an account is allowed a returns provision of 20 percent. It is also possible to negotiate for zero returns (a “firm sale”) or allow a retailer 100 percent returns. A 100 percent returns allowance usually occurs when either a retailer has enough clout to insist on this flexibility, or the retailer has agreed to take extra units and aggressively market the title. Regardless of what is negotiated, it is important to keep in perspective that these provisions may change after the fact—a retailer that has agreed to 20 percent returns and finds that the title significantly underperforms is likely to ask for relief and return a much higher percentage. If this is a key customer and the distributor has another title coming out the following month it wants to push, it may not be so easy in practice to rigidly
enforce the hard 20 percent number. The success of a title ultimately depends both on the distributor and retailer market, and both parties need to juggle short-term performance versus long-term relationships. This is where friction arises with producers, as someone involved with a specific title will not accept the sacrifice of his or her title’s performance to accommodate client relationships that may bear no direct impact on his or her film’s video revenues.

Return Reserve

For accounting purposes, returns caps allow the distributor to take return reserve provisions; namely, in accounting for sales, a provision will be taken for returns based upon the contractual return allowance or a permitted reserve. When accounting for sales, there is always a gap, and several elements need to be reconciled: What has been shipped into the retail channel? What units have actually sold-through to date (bought by a consumer as opposed to bought by the store)? What number of units is likely to remain at retail for future/continuing sales? What number of units is likely to be returned?

Returns impact participation statements (see Chapter 10) and need to be looked at in terms of how returns are treated between the distributor and retailer, and how returns are accounted for between the distributor and the producer/participant. There may be separate deals, and this may not be (though often is) strictly a pass-through relationship. One can theoretically imagine a producer with sufficient leverage inserting a returns cap in its deals to protect against a distributor favoring a retail customer or making a decision based on retail relationships as opposed to strictly on the title.

There may also be contractual provisions regarding the timing of returns and reserves. In
addition to or unrelated to a returns allowance percentage, the parties could strike a deal prohibiting returns for a period of time (e.g., no returns for 90 days or six months); this has the advantage of keeping the product on shelf, and may allow for increased sales over a different or incremental selling season that would not take place without the protection (shelf space otherwise ceded to a competitive title).

On the participant side, there may be a push to stipulate that returns allowances may only be taken for a limited period of time and then released; it is customary to negotiate periods during which returns reserves need to be liquidated. Because the reserves are allowed, the distributor will naturally take advantage of potential returns and keep the money (in anticipation of returned units); however, these returns may never materialize, and all the while the money is held and not paid over to the producer. This practice, which is equivalent to the concept of “float” in other industries, means that the negotiated reporting and liquidation periods can be quite significant.

Spotlight on DreamWorks Animation and Pixar in 2005

The issue of returns was highlighted in 2005 when both Pixar and DreamWorks Animation were hit with returns on, respectively, The Incredibles and Shrek 2.

The tempest was set off by DreamWorks statements and filings. In January 2005, DreamWorks Animation stated that it had sold 37 million units of Shrek 2 worldwide. However, in March the studio reported that it had only sold 33.7 million units and that it expected the title to continue with a strong performance and sell over 40 million by the end of the first quarter. When the day of reckoning came in May, DreamWorks Animation reported that it had only sold 35 million units (not 40 million), and admitted that the rate of sales that propelled the title to the
top video seller of 2004 did not keep pace into 2005.

The reporting caused DreamWorks Animation’s stock to fall 12 percent on the disappointing earnings, and the entire issue of returns and slowing down of the video market started making headlines. The Wall Street Journal reported: “In just its second quarter since becoming a public company, DreamWorks fell short of earnings forecasts by 25 percent and its stock tumbled as Wall Street wondered why the mistake wasn’t disclosed sooner.”

Beyond the hit in stock price and negative publicity, the misjudgement on sales and returns even led to lawsuits, which in turn made headlines:

Shrek 2 DVDs Subject of Lawsuit. Shareholders sue DreamWorks alleging misleading projections. . . A proposed class-action lawsuit, filed in federal court in Los Angeles today, seeks unspecified damages from DreamWorks Animation for allegedly misleading stockholders about prospects for sales of Shrek 2 DVDs.”

In the wake of this news, Pixar warned that it would have larger-than-expected returns on The Incredibles; on June 30, 2005, Pixar cut its earnings per-share estimate for the second quarter from 15 to 10 cents, citing slower-than-expected sales. The issue became prominent enough that even the SEC started to examine the reporting process for each of these studios. Ultimately, the SEC’s local arm investigating DreamWorks recommended that no enforcement action be taken, and Variety reported: “While the SEC itself still has to make a formal decision, recommendation makes it very likely that DWA will escape government sanction for failing to warn investors, before first-quarter earnings were announced last year, that returns on the Shrek 2 DVD were running much higher than anticipated . . .”
While the issue of returns seemed like a revelation to the press and some investors, the difficulty of managing inventory levels and balancing returns was nothing new to industry insiders. What had changed were two factors. First, as earlier discussed, there was a slowing down of sales in the industry, and within 2005 the market seemed to have hit its by-title ceiling; the overall market was still healthy, but with title saturation and withering competition the market appeared to be retrenching on the high end of sales. This was a trend that had been predicted, but the reality came quicker than anticipated and started to send shock waves through the market. Second, with a microscope on the industry, there was the ability, in the case of both Pixar and DreamWorks Animation, to see the impact on a specific title. This transparency was rare, for studios would otherwise report numbers on a consolidated basis, and to outsiders it was impossible to glean the numbers or even trends on the basis of a single title. With The Incredibles and Shrek 2, there was no way to hide the line-item performance.

Format and SKU Variables

An important variable in managing inventory and returns is also managing product SKUs. In some cases, a video or DVD release will be split into pan-and-scan and widescreen versions. Typically, a traditional box-shaped TV screen plays a 4:3 aspect ratio, which is referred to as pan and scan. In contrast, the horizontal aspect ratio of widescreen, replicating the rectangular movie, is 16:9. The widescreen aspect ratio matches the way a movie has been shot and edited, capturing the full breadth of the scene. To create a pan-and-scan version, the filmmaker actually has to create and approve another version, because the picture cannot simply be squeezed into the other shape. Accordingly, a pan-and-scan version will often cut off images at the margins.
The advent of widescreen monitors and increased consumer market knowledge led to an increase in widescreen versions. For years, pan-and-scan dominated, as widescreen was limited to the “purist” consumer who wanted to see the picture as the director intended it/as seen on film, so elements and scope are not compromised (and would put up with the black bars at the top and bottom of the screen). With the market maturation, plus increased consumer awareness of formats and the growth of rectangular flat-screen monitors, the SKU balance started to equalize on “collector”-type titles. By 2003–2004, certain titles were selling a greater number of widescreen versions, a trend that had been predicted but until this point of intersection (DVD growth and alternate monitors) had not happened. With each year, the proportion continued to shift in favor of widescreen—in fact, widescreen has become the de facto standard with pan and scan set to disappear.

Finally, in terms of SKUs, studios started to offer special “2-disc sets” of key titles, with one disc containing the film and the other disc filled with bonus material (or, in video parlance, value-added material or “VAM”; see Chapter 9 for more discussion of VAM in the context of marketing). The extra material both justified a higher price point and had become a self-fulfilling expectation from the standpoint of consumer demand—once it was commonplace, it became an expected component. The net result of the bonus disc was the studio distributor had a choice whether to release one version including the bonus material, or two versions with the alternate SKU comprised of just the film disc. If two SKUs were released, this obviously complicated the release matrix: Would the physical packaging change? Would the artwork change to distinguish SKUs? Would the price points vary? Would the distribution points of sale change?

Today, the existence of “VAM” can be a differentiator helping justify the purchase of physical versions versus digital copies that frequently only offer the movie or TV show itself. In
a world with cloud access and storage and digital rentals via Netflix and cable VOD, VAM offers premium content valuable to the collector and often only available with purchase.

Pricing, Price Reductions, and Price Protection

Pricing is not quite what it seems from customarily quoted numbers, and to understand the economics it is important to appreciate net pricing. The price charged by the retailer to the consumer is called the retail price. Because it is illegal to set an onward price, what is usually set is the SRP; MAP is a vehicle to influence the SRP, but ultimately there is market flexibility and neither the SRP nor MAP actually locks a retailer into a specific sales price. (Note: When you hear about a store advertising as a low-price leader, or matching in the market, it is important to discern between whether a specific store in the chain will alter pricing within the store to match a competitor, or whether the chain/store is actually advertising a specific price to the consumer. It is very different to claim you will match a price (where no figure is stated in the ad) and to actually advertise a specific price in newspapers and circulars.)

The price that the distributor charges the retailer is often called the dealer price, which is the video term for wholesale price. As a rule of thumb, the wholesale price tends to be roughly 60 percent of the SRP. The wholesale price is basically fixed across the U.S. market (in accordance with the Robinson–Patman Act); nevertheless, there can be marginal account differences in the wholesale price, as juggling can take place with marketing allowances (market development funds and cooperative advertising allowances) and tailored programs.

Like any consumer product, over time there are markdowns as new items enter the market. In the video sector, product is generally segmented into “new releases” and “catalog.” When a
product transitions from a new release to catalog, however, the price is not fixed, although generally product is re-categorized after its initial release cycle. The challenge of a distributor is to manage its library of titles, find ways to turn over its catalog titles, and maintain demand and premium pricing for the key titles in its library. Accordingly, segmenting the library becomes an important marketing proposition, and to generate demand and interest titles are often themed or grouped (e.g., marketed as classics, award-winners, part of director’s collections).

In terms of life-cycle management, studio distributors are always running models (and conducting market research) comparing units and corresponding contribution margins at differing pricing; for example, will dropping the price from $19.99 to $14.99 generate sufficient incremental sales to outweigh the lower per-unit profit? Managing price is an art, not a science, and is influenced by factors such as the nature of the title, the competitive environment, retail pressures, inventory in the market, seasonality, life-cycle promotional opportunities, and rebate programs.

On a typical release, it would be customary to release at a higher price (but a price that hopefully yields maximum net profit/contribution, taking into account the matrix of pricing and volume), and then to reduce the price downstream; for example, if a movie came out at Christmas, and the video came out in late spring the following year, the price may be reduced in the fourth quarter for a Christmas promotion. If competitive product pricing is lower, there will be retail pressure to match, and subsequent price reductions will be implemented. All this activity may generate incremental sales, but there are two issues that need to be weighed. The first is that, except in rare instances, it is very difficult to raise a price—once it sinks to a certain level, it is apt to stay there. Namely, once in the bargain bin, it will be very difficult for the distributor to sell more units into a retailer at a higher price. The second key issue is price
What is Price Protection?

Price protection is money paid by a distributor to a retailer when the distributor drops its wholesale price and sells more units into the market at a price below what it charged the retailer for the retailer’s previously purchased on-hand inventory. For example, if Studio X sold units into the market at a wholesale price of around $12, such that Retailer Y generally priced the title at $19.99 to the consumer, and the studio had a promotion where it wanted to sell in more units of the movie at $9 to drive a retail price of $14.99, it might have a price-protection issue. The issue would arise because retailers would have current stock at the higher price, and would want to be equalized such that all stock had the same cost basis. To take in more units, it would insist that the studio pay or credit it back the difference between $9 and $12 on all units it had. This $3 difference is the price-protection payment charged to the distributor.

The retailer holds the leverage here. If the studio does not equalize the stock, the retailer would likely have the option to return its unsold product for full credit.

Price protection generally occurs in two scenarios. The first is when a title has been successful and there is an opportunity to sell in additional units, such as implementing a seasonal promotion dropping the price after the title has already been in the market for a period. Even with success, individual stores within the same account are apt to be out of stock and others to have excess units—in a perfect world, the retailer would stock balance, excess units would sell-through, and price protection would not be needed; however, the reality is the distributor is likely to bear the brunt of this evening out via price protection, which, if executed well, may only be a
credit against new units sold in and would not incur any actual out-of-pocket cash payments. A second scenario can occur when a title has severely underperformed. If a title is not selling-through, and there is so much excess inventory that retailers are threatening to send it back (retailers will want to maintain whatever product is generating turnover and margin), then the distributor may need to drop the product’s price just to keep it on shelves. If they can convince accounts to take in more units when the price is dropped, then there is the potential for netting the price-protection costs against the additional revenues from new units—a scenario akin to a successful title; however, if new units are not ordered or the units do not generate enough revenues to cover the price-protection costs, then the distributor may have to pay the difference in cash. Usually, return reserves will cover this deficit, but if price protection is needed to keep the title on shelf and the liquidation of return reserves (sums held to offset returns) provides insufficient funds, then the distributor can find itself in the lose-lose position of lower price (and therefore reducing its margin) and paying cash out of pocket for the privilege of cutting its margin. This can, obviously, be a disaster scenario.

Point-of-Sale Rebates

While price protection impacts the entire channel and effects a permanent pricing change, point-of-sale (POS) rebates are a mechanism to implement a temporary price rollback. A supplier may authorize a limited-time price cut, either across the retail channel or with specific accounts, which is implemented at checkout. To create an incentive for the retailer to reduce the shelf price from $19.99 to $14.99, a supplier may offer a $5 POS rebate, which will be applied at the wholesale price level, with the expectation that the full discount will then be passed along to the
consumer, lowering the shelf price as just described. The advantage to the supplier is that they only need to credit the stores for units actually sold rather than on the entire inventory. This is a strategy frequently used for promotional sales, or during key holiday periods where the seller is trying to move units during periods of heavy foot traffic, but where the seller does not want to implement a permanent price cut.

**Moratorium**

Another tool that a distributor can use both to manage inventory as well as pricing is to put a title on moratorium. This means simply that the title is no longer available for purchase. By limiting supply, this may help stabilize either pricing or inventory levels, as stores may be less likely to return product if they are unable to later reorder units. Also, putting a title on moratorium may stimulate sales: “order now or else . . .” Disney has used this strategy very effectively on its animated classics, advertising that a title is available for a limited period only, helping to spike interest and demand. The product is then literally rested until another cycle or perhaps another special version is later released.

Putting a title on moratorium is especially useful in the instance of multiple SKUs. This may help send a message to retail that the current version of a title will not be replenished (staving off potential returns), and further limits supply to clean out the channel before a different version is released. One of the goals is to avoid market confusion, so that the new version (e.g., a special edition) is the only widely available version, allowing focused marketing campaigns both at the retail and consumer levels.
Price Erosion and Bargain Bins

One of the most difficult elements in managing a title or catalog is dealing with price erosion. As noted earlier, new titles can command a premium price, but once the initial sales cycle has passed the product is perceived as older and will often be repriced in an effort to stimulate sales.

What counters price erosion is that, unlike consumer goods, which are fungible, every movie is a unique piece of software. There will only be one *The Godfather* or *Titanic*, and pricing does not need to drop for that film to compete because there is another identical product coming into the market; instead, pricing may need to move for the consumer to view the title as competitive against other similar films. If a competitor has a classics line that underprices its rival studios, price sensitivity alone may influence the consumer’s selection.

Managing consumer expectations is tricky, and, as previously noted, once there is a perception that pricing is at a certain level, it can be difficult to move back up to a higher cost basis. Ultimately, pricing is based on brand and catalog management, and can be influenced by seasonality, new formats coming into play, inventory levels, and even corporate revenue pressures (e.g., dropping a price and stimulating sales can help achieve hitting an earnings target).

It is now common for certain retailers to sell older titles in “bargain bins,” where consumers may buy DVDs for a couple of dollars. Even high-profile titles can be steeply discounted for promotions, as has been the case on Black Friday in the U.S., when some of the *Harry Potter* titles and *The Lord of the Rings* films could be found in the $5–6 range. This is a far cry from the former high-priced rental market, and many video distributors bemoan the price erosion in the market. The discounting may be fine if volume is stimulated, but if volumes do not meet
projections and the pricing becomes a consumer expectation, rather than a limited promotion, then the high margins the business has enjoyed are put in jeopardy.

Ultimately, there are no other *Harry Potter* movies, so how and when to move price and launch promotions is the realm of brand management that makes the video market so interesting. Again, even though all films fall into categories, all individual films remain unique, challenging video divisions to hit targets by simultaneously macro- and micromanaging its catalog of product.

**International Variations**

*The following is reproduced from the Second Edition without modification*

*Release Timing and Development of Market*

Although video and DVD technology has been driven by European and Asian (in particular Japanese) consumer electronics companies, market growth and penetration has been driven by software and Hollywood pressures. The international video and DVD markets have usually lagged the United States in terms of maturation and retail sophistication.

In terms of retail and consumer patterns, the DVD and Blu-ray market has generally mirrored the prior VHS sell-through market. In territories such as France, for example, where there was a long sell-through tradition and sophistication of key retailers such as the hypermarkets (Auchan, Carrefour) the DVD market has followed a similar pattern. Accordingly, key retailers such as the hypermarkets, or entertainment software chains such as Virgin Megastore or FNAC, tend to have the same challenges that exist in the North American market: How is the product merchandised? How is it displayed? What are the promotional campaigns? Is the price point appropriate?
Additionally, with sophisticated merchandising and placement usually comes quality reporting. The ability of the distributor to see through to actual consumer sales forces the development of state-of-the-art inventory management systems and distribution that allows quick, store-level replenishment. Stock balancing can occur on a daily, and at minimum weekly basis, affording the distributor to respond to consumer demand while maintaining a greater level of flexibility in creating product.

The ability to tinker with stock balances, replenish inventory, and top up manufacturing is only possible with this level of reporting from retail, and the parallel ability of retail to handle changes rapidly. The type of systems that can report and consolidate by-title sales at store and chain levels on a daily basis, however, are only justifiable with certain threshold volumes; in essence, the entire supply side feeds on itself with volume driving sophistication, and fulfilment, merchandising, and manufacturing capabilities evolving with demand. The United States is such a large market with diverse and distant retail distribution requirements that it developed this level of maturity quickly. That process has lagged in many international markets, but has now caught up in sophistication across the territories one would expect (e.g., much of western Europe, Australia). (Note: Not surprisingly, many of the trends discussed above, including, for example, the use of reserves and price protection, is similarly applied in the sales and stock balancing of other physical copies of packaged goods media, such as videogames; additionally, as the same mass-market retailers tend to stock both movies and games, inventory systems have improved and have, to some measure, converged—though movies/DVDs are still managed separately.)

Outside the pure supply chain, considerations such as competition and external factors in the local marketplace tend also to mimic the U.S. market. Regarding external factors, video releases may be tied to natural key sales periods, such as national holidays and vacation periods. As for
the impact of competition, all distributors similarly analyze the release schedule of competitive product and date ("street date") their releases to try to secure the optimal window for sales.

Any and all of these factors are reasons why a DVD may come out on a different date in different territories. Weighing against these factors, however, will be concerns about piracy and parallel imports: once a product is out in the worldwide marketplace, there is a danger it may find its way to the local consumer before the product has been directly released in the country—an issue that is now exacerbated with Internet access, especially for English-language product.

Localization Challenges

The main challenge of international markets is the creation of language-specific SKUs. Each DVD will need to be authored and compressed like the United States, but across the rest of the world there will be multiple SKUs covering both dubbed and subtitled versions.

In addition to language versions, marketing campaigns will be tailored to the specific market as will, in cases, the packaging. Whenever a creative campaign is changed, and especially when it is uniquely tailored to a specific territory, there is inherent delay. Additionally, depending upon contractual requirements, time may need to be allocated to obtain approvals from talent, as well as for home office executives to coordinate their approvals with both international branches and the producer/production company that made the film. Hopefully, these elements have been planned for (and lead times built into release schedules), but the potential for delays is obvious.

Pricing: Variable Pricing to Customers and Net Pricing
Pricing internationally can be a “free-for-all” relative to the U.S. market where distributors set the same dealer price for all customers and do not differentiate price based on volume commitments. Instead, distributors have to manage the retail channel by other means, including marketing commitment (co-op marketing and market development fund), returns policies, inventory placement, etc.

In contrast, historically in some European markets and specifically in highly price-sensitive retail markets, the distributors may set different prices for different customers. Not only can the actual dealer price vary, but there may be different discount schemes applied to varying accounts with variable pricing at each stage of the chain: retail/shelf price, dealer price, net invoiced price.

<table>
<thead>
<tr>
<th></th>
<th>SRP</th>
<th>DLP</th>
<th>DLP as % of SRP</th>
<th>Discounts*</th>
<th>Rebate</th>
<th>Net Price</th>
<th>Shelf Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>24.99</td>
<td>14.30</td>
<td>20</td>
<td>5</td>
<td>11</td>
<td>22.99</td>
<td></td>
</tr>
<tr>
<td>France</td>
<td>24.99</td>
<td>20.50</td>
<td>25</td>
<td>—</td>
<td>15.40</td>
<td>24.99**</td>
<td></td>
</tr>
<tr>
<td>UK</td>
<td>24.99</td>
<td>17.00</td>
<td>20</td>
<td>2</td>
<td>13.20</td>
<td>15.99</td>
<td></td>
</tr>
</tbody>
</table>

* May be further subcategories, such as cash discounts and standard discounts.

** In France, it is a regulated market and the shelf price—SRP.

Obviously, the distributor needs to ensure a certain range to avoid chaos and resentment in the marketplace. This is usually achieved by applying larger discounts to key accounts, which in turn often break out based on relative volumes. While this may all sound simple in practice, think about having to account for net pricing at the retail-chain-specific level, rolling up to the market
overall, and then equalizing pricing by backing out applicable VAT taxes and harmonizing exchange rates. The simple question, “What is the price in the market?” could easily have different answers.

Table 5.5 is an example. Within each market, the distributor needs to customize its terms with retailers, and will generally fix both the SRP and the DLP; however, the wholesale price/DLP may have significant discounts applied that can be sliced in a variety of ways. There may be standard discounts and rebates, which may be within a continuum (e.g., standard discounts within a band of 20–25 percent), or the formula may be quite complicated. Some markets may apply layers of discounts, applying at chain level and tied to variables such as cash payment/payment terms. Accordingly, historical relationships, retailer-level commitment to placement and marketing, trading terms, payment terms, volumes ordered, and return provisions all factor into the relationship matrix and ultimate per-unit/per-retailer pricing structure.

Another factor that is quickly impacting pricing patterns is the Internet. By cutting out the middleman, certain e-tailers can effectively undercut traditional retail pricing. This puts pressure on margins, which comes back to the distributor in the form of physical retailers wanting additional discounts. In markets where differential dealer pricing based on volume commitments is legal, this can create enormous challenges in managing the market.

\textit{Video Costs}

\textit{[The following has been reproduced from the Second Edition without modification]}

Probably the best way to illustrate video costs is to walk through the costs at various stages of exploiting a new-release DVD or Blu-ray title. I will break this into three sections: building and
encoding the DVD material, manufacturing the DVD, and marketing and distributing the DVD. Paralleling the complexity of the DVD supply chain, the logistics of creating, manufacturing, and fulfilling DVD orders is a complicated process. The DVD is an inherently complex product and the physical plants are high-tech, secure, impressive facilities that rival the efficiency of any assembly line.

Building and Encoding DVD Material

The first stage consists of two parts: what material will physically appear on the DVD, and how that material will be converted to compressed digital form. Regarding the materials, it is important to recognize on the cost side that a DVD involves much more than simply transferring a film or TV show to the DVD. The value of the market and ability to tinker after the fact have created a consumer value proposition mandating that the DVD (for a major title) offers something extra. That something extra includes vast amounts of VAM, as well as navigation. (Note: As discussed earlier, VAM may not be offered in rental options, and some consider VAM the differentiator justifying purchase of a title; essentially, VAM can be leveraged as a mechanism to preserve sell-through/ownership tied to higher price points in an environment when cloud access can otherwise eliminate the impetus to purchase.) The entry point to a DVD is called the menu, and each major DVD has a uniquely produced menu and interface to enhance the experience. This is the interface screen that asks whether you want to watch widescreen or pan and scan (if the particular DVD gives you a choice), has a play button, and lists the other options that the particular DVD may give you. This can include traveling to all sorts of VAM, jumping to specific chapters, hearing director or talent commentary, watching trailers or altering
the presentation settings.

All of these choices are then integrated to a user-friendly environment that will thematically pull from the title. The page may be static, scrolling, or may have visual cut scenes that play and then dissolve into the static menu page. All of this obviously takes time and money, and depending on the budget and consumer expectations, very significant sums can be spent creating additional material and the navigational interface through which the consumer can explore the hours of extra content. Because of these features, the DVD has become an interactive product, allowing the viewer to customize his or her viewing experience and delve into extra features that can be much longer than the actual content around which this VAM is built. It is not unusual for a major two-hour film to come with four or more hours of “bonus material.”

Once all the elements are set (the title, the menus, and the bonus material), then all the material needs to be encoded. This step is called authoring and compression, which is technical lingo for transferring the material to the digital medium. There are specific authoring and compression houses who bid out product and create the masters from which the DVDs are then replicated. There has been a natural consolidation of video replicators and compression houses; in fact, some of the replicators have acquired authoring companies, thus allowing them to offer customers one-stop shopping through the production chain. Similar steps are required for online/digital versions delivered via broadband access, or cloud-based and other over-the-top distribution channels, as discussed in Chapter 7. In those instances, content is ingested and transcoded as appropriate for delivery via servers that then provide VOD access through digital rights management software. DRM systems, coupled with additional security through transmission and playback schemes, then enable consumers to gain access to the content based upon whatever rules (How long is the access? How many times can a program be viewed?) are
put in place and economic systems (e.g., rental versus sell-through) are offered.

The cost of authoring and compression has come down over time, with improvements in both technology and competition. One of the more significant costs comes from the international side, where different language masters require several different masters to be configured, authored, and compressed.

Manufacturing the DVD

Manufacturing costs are broken out into pennies—and pennies matter in a business with slim replication margins and unit volumes that can be in the several millions. Like any other good, the manufacturing costs of physical discs are a roll-up of lots of sub costs, since every DVD/Bluray is customized.

As a rule of thumb, usually half to more than half of the total costs come from the physical replication of the disc and the cost of the plastic DVD case (Amaray case). What the actual disc costs are per unit will vary according to vendors and market conditions. Many studios have overall long-term deals with replicators. The vendors benefit from having secure capacity filled, and the studios benefit by incentives to lock up their business. If a distributor is able to bid out replication on the “spot market,” they may or may not strike opportunistic deals. If the manufacturing is in the peak period where every studio is pumping out DVDs for the fourth-quarter gift season, and capacity is constrained, then costs may go up. However, depending on the replicator, its particular flow of product from its studio deals may be up or down depending on the actual title performance (does the studio have three hit titles or three dogs?), and pricing may fluctuate given the actual capacity expected. One thing is for certain: every studio wants
secure capacity with the absolute lowest price, which virtually ensures a consistently competitive market.

The following are examples of the types of elements in the manufacturing process that go into assembling a finished-goods price:

- physical disc replication, for which price may vary by the memory size of the DVD
- price of the Amaray case
- costs to create/print menus, sleeves, and then insert the material into the case
- spine labels
- security tags (different retailers may require different tags/configurations)
- booklet and disc insertion
- shrink-wrapping the finished product
- external stickers
- barcodes
- freight costs for delivery (if distribution bundled with manufacturing costs).

The above is the baseline, as the process can become more complicated for special gift SKUs, bundling product together (e.g., pack-in toy), or special cases.

One great advantage DVDs had, which helped spur adoption, was that the physical replication costs were low when compared to making a VHS tape. The costs continued to drop over time, so not only were more DVD units of a title being sold, but the margins based on manufacturing alone were in parallel going up. The timing, product, and type of DVD (e.g., DVD-9 or DVD-5) can all influence price. As noted previously, this is a negotiation of pennies,
and it is the pennies that ultimately determine the margin and profitability of the DVD duplicator.

**Marketing and Distributing the DVD**

*The following is reproduced from the Second Edition without modification*

(Note: The following is a summary overview of some key costs; for additional information, please also see discussion in Chapter 9.)

Marketing of DVDs entails two primary costs. The first is the consumer marketing and advertising campaign costs borne by the studio distributor. This entails the same types of categories as theatrical marketing, ranging from print ads, to TV spots, to online promotion—where online promotion itself is now diversifying to segment digital advertising promotion and leveraging social networks. Beyond paid-for media, advertising costs (again, like theatrical) also include posters, trailers, press/PR activity, and even junkets. As the upside for DVDs/Blu-ray has grown, the marketing campaigns have become that much more complex—often planned months, if not a year, in advance of the release.

The other major cost category is trade marketing, given the importance of incentivizing retailers both to execute at point of purchase and to advertise themselves, utilizing DVD/Blu-ray product to attract store traffic. As mentioned earlier, distributors will therefore offer market development fund and cooperative advertising allowances that the retailers may spend on in-store campaigns, circular advertising, and general promotions (including online banners, homepage and above-the-fold placements, etc.). These sums are variable and tied to a percentage of
wholesale revenues: the more units bought, the more money available for promotion.

Sometimes, with a significant enough title, the retail campaign can also be stimulated with customized product or tie-ins. These can take the form of retailer exclusives, special product SKUs (e.g., double packs, packed-in merchandise), and rebate programs. If programs are customized by the retailer, then a key customer such as Walmart or Media Markt may be able to differentiate its offer and advertising, creating an incentive for the chain to advertise the product and perhaps feature the unique SKU in circulars. There is no limit to tie-ins, and with the release of the DVD for Star Wars: Episode III – Revenge of the Sith, Fox and Lucasfilm executed a unique program with Best Buy involving the Donald Trump television hit The Apprentice; the task for the contestants on the show was to build a display that would showcase Episode III and related product (Star Wars video game) at Best Buy stores, and then a version of the winning team’s display would be utilized in select Best Buy retail outlets.

Finally, in very limited instances there may be the potential for promotional partners, akin to theatrical tie-ins. It is the bane of video marketing chiefs that, despite the size of video revenues, and the critical importance of DVD/Blu-ray sales in the life cycle of any title, such deals are the exception and not routine. DVD sales simply do not piggyback on marketing waves of theatrical release scale and are still largely viewed by consumer brands as ancillary.

CHAPTER SIX: Television Distribution

2nd Edition Table 6.1 Table of Broadcast Television Networks

<table>
<thead>
<tr>
<th>Television Network</th>
<th>Founded</th>
<th>% of U.S. Households</th>
<th>No. of Households</th>
<th>Type of Network</th>
<th>No. of Full-Power Affiliates and</th>
<th>No. of Low-Power Affiliates and</th>
</tr>
</thead>
</table>

145
<table>
<thead>
<tr>
<th>Network</th>
<th>Year</th>
<th>Affiliates</th>
<th>Viewable</th>
<th>Transmitters</th>
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</thead>
<tbody>
<tr>
<td>PBS</td>
<td>1969</td>
<td>349</td>
<td>105,579,120Non-profit</td>
<td>342</td>
</tr>
<tr>
<td>ABC</td>
<td>1948</td>
<td>229</td>
<td>103,179,600Commercial</td>
<td>266</td>
</tr>
<tr>
<td>NBC</td>
<td>1946</td>
<td>226</td>
<td>103,624,370Commercial</td>
<td>338</td>
</tr>
<tr>
<td>CBS</td>
<td>1948</td>
<td>215</td>
<td>103,421,270Commercial</td>
<td>299</td>
</tr>
<tr>
<td>Fox</td>
<td>1986</td>
<td>203</td>
<td>102,565,710Commercial</td>
<td>202</td>
</tr>
<tr>
<td>The CW</td>
<td>September 18, 2006</td>
<td>158 +</td>
<td>102,565,710Commercial</td>
<td>11 (5 cable-only stations)</td>
</tr>
</tbody>
</table>

Data from Wikipedia

(http://en.wikipedia.org/wiki/List_of_United_States_over_the_air_television_networks)

Excludes My Network TV.

**Decline of Ratings for Films on TV**

*The following is reproduced from the 2nd Edition without, in most instances, modification*

It is an acknowledged fact that ratings for films on TV have declined over time, and there are several factors frequently pointed to explaining the slide. Among these are the growth of DVD, the growth of other media options such as the Internet, fragmentation of the TV market with the growth of cable, waning tolerance for viewing films with commercial breaks, the ability to consume the film earlier via ancillary platforms such as VOD and PPV, the changing profile of network scheduling and programming (e.g., reality craze), and, of course, piracy.

It is no doubt also true that before the growth of the home video market, TV had a more dominating impact: there was a large audience that had never seen the movie, and no matter how
big a film was at the theater, the reach of tens of millions of eyeballs on TV inevitably dwarfed the numbers that had physically seen the movie in cinemas. With movies selling in the millions across downloads, digital lockers, and DVDs, and the expansion of ancillary windows/access, including VOD, allowing earlier consumption, clearly prior exposure has contributed to the decline in ratings of films on TV. In the 1980s when a film played on television, this was its first and primary exposure after the movie theater; now, however, by the time a film is on free television years downstream from its theatrical release, there have been innumerable opportunities to “consume” the movie on a variety of platforms (and, regrettably, both illegally as well as legally).

**Shared Windows, Shorter Network Licenses, and Clout of Cable**

With the decline in network clout and the growth of cable channels, the traditional sequential TV windows are becoming more of an historical artifact. There are instances where films go to network, and then cable, and then syndication; however, it is now common for cable stations [or now SVOD streaming services] to buy out network windows or to partner with networks on shared long-term windows with oscillating periods of exclusivity. The playing field is relatively level, and cable stations such as FX, USA/Syfy, TBS/TNT, Spike, Bravo, and the ABC family compete with, and in cases are, the frontrunners to the networks, even in cases where the networks may be an affiliated sister company. Because the licensors are trying to garner the best deal for their specific film or package, the best option may cut across different studio lines and strange bedfellows can emerge.

Ranges of fees are tightly guarded, but 2nd Edition Table 6.2 outlines several high-profile
deals typical of the market’s high end, and also illustrates how some films will share windows between cable and networks.

It is also worth highlighting that as cable clout grew, and especially in the instance of hybrid licenses where cable stations and networks share runs, the licensed runs and period for networks shrunk shrinking. Whereas it may have been typical to take three to four runs, scenarios arose where networks may only take one or two runs.

2nd Edition Table 6.2 Movie Licensing Fees

<table>
<thead>
<tr>
<th>Film</th>
<th>Network</th>
<th>License Fee</th>
<th>Term</th>
<th>Source</th>
<th>Windowing/Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Spider-Man 2</td>
<td>FBC and FX</td>
<td>$50 million</td>
<td>10 years</td>
<td>HR, June 30, 2004; Variety, June 29, 2004</td>
<td>Rumored carve-outs for a second network window after first 3 years</td>
</tr>
<tr>
<td>King Kong</td>
<td>TNT and ABC</td>
<td>$26.5 million</td>
<td>8+ years</td>
<td>Variety, February 14, 2006</td>
<td>Noted $22 million TNT first 6 months + 50 months post ABC; ABC $4.5 million for three runs over three years following initial TNT exclusive window</td>
</tr>
</tbody>
</table>
2007

<table>
<thead>
<tr>
<th>Film</th>
<th>Channel</th>
<th>Budget</th>
<th>Timeframe</th>
<th>Source</th>
<th>Windowing Rights</th>
</tr>
</thead>
<tbody>
<tr>
<td><em>Avatar</em></td>
<td>FX</td>
<td>$25–30</td>
<td>6+ years</td>
<td><em>Variety</em>, January 7, 2010</td>
<td>Standard windowing post HBO pay rights</td>
</tr>
<tr>
<td><em>The Hangover Part II</em></td>
<td>FX</td>
<td>$24 million</td>
<td></td>
<td><em>Deadline</em>, May 31, 2011</td>
<td>Part of 13-title package</td>
</tr>
</tbody>
</table>

**How Barter Sales Work (Plus advertising in syndication and coverage required)**

This pseudo-live nature of a network broadcast is what makes it so powerful: the network can reach an enormous number of people with the same programming at the same time. This cross section allows for targeted marketing and scheduling, which in turn allows for targeted advertising. Despite the explosion of new media options, there is still no better way to reach a population of over 250 million people. Broadcasters know that a certain percentage of X demographic will watch the nightly news at 6:00 p.m. versus Y demographic for a sitcom in primetime. And the game is all about that sole fact: how many eyeballs of which type (here, young versus old, male versus female, kid versus adult) will see the program.

Syndication, in contrast, is still about drawing eyeballs, but the task can be more challenging when the promotion is solely at a local level.

There is no absolute magic threshold for coverage, but there is a certain quantum of coverage that rises to the level of “significant.” That benchmark is usually in the 70 percent or more range. The composition of the coverage is often a hodgepodge of stations. It could mean an ABC
affiliate in Denver and Dallas, a Fox affiliate in Los Angeles, and independent stations in Kansas City and Seattle. There are sometimes certain station groupings, such as the former “WB 100,”
that may license together, which can achieve a chunk of coverage in one deal.

Achieving a certain quantity threshold of coverage is critical for attracting advertisers, as
many will not consider a program that does not hit an internal mandated coverage threshold (e.g.,
80 percent of nationwide coverage). Beyond the absolute percentage, however, advertisers will
look at both the quality of stations and the programming time. For a national buy, there will
usually need to be a significant number of top stations in key markets. If, for example, there are
no network-affiliated stations carrying the program in the top 10 markets (e.g., no network
affiliates in Los Angeles, New York, Chicago), then it is obviously a hard sell. Sometimes this
can be overcome with a strong enough station grouping, such as a percentage of Fox- or ABC-
affiliated stations.

Because the syndication quilt will not achieve simultaneous broadcasts, advertisers will also
be keenly interested in the time slots. It may be great to have a Chicago station, but if it is a CW
station broadcasting a kids’ show at 5:00 a.m., then the value is clearly very different than had it
been an ABC affiliate at 8:00 a.m. It is because of this particular challenge of trying to aggregate
and secure advertising commitments across unaffiliated stations in less than full market coverage
with non-synchronized broadcast times that anyone in this business needs a good advertising–
sales team. The nature of the beast is such that it may be difficult or impossible to secure a
national spot/advertiser, and that advertising needs to be sold on a market-by-market, broadcast-
slot-by-broadcast-slot basis. Because syndicators may air a program more than once a week, the
matrix of total telecasts becomes quite complicated to manage. (Note: See also Chapters 3 and 7
regarding the challenge of pricing fragmented online/Internet viewing, as akin to a form of
national or global syndication, whereas traditional TV syndication sells advertising locally.)

Barter as a Solution to Fragmented Sales and Airings

Making this task of selling ads even harder is the speculative nature of viewership. Because of the fragmented placement, marketing can only be committed at the local level, and ratings are only meaningful within the discreet local market. Accordingly, what has emerged is a barter market.

The term barter syndication is often used in this context, and means a sharing of the advertising time. If a 22-minute program is shown in a 30-minute block, that may leave approximately seven minutes of advertising space to sell (excluding time reserved for station promos). The licensor of the program may “own” all or part of this time, and is betting on the fact that he or she can sell the space for better terms than he or she would otherwise receive for licensing the program outright. This is also a mechanism for the station to hedge its bets and lower program acquisition cost. It may be better for a station to pay $1,000 rather than $3,000 for a program and cede some advertising time to lower its costs.

In this instance, the station is obviously betting on a couple of factors. First, it is assuming that the value the licensor will achieve from selling the advertising inventory is less than the discount the station has granted. Second, the station is assuming that there is residual value/benefit to having the programming; it draws viewers to the station generally in the time period, viewers are not going to a competitor, and viewers may stay tuned in for other programming because of coming in the first place.

There are even instances of full barter, where the station pays nothing and the licensor
achieves any and all financial benefit from selling the space it retains. In this situation, the station may reserve some spots and have a pure upside from selling inventory against no-cost basis. Of course, there are always opportunity costs, and the buyer needs to value whether another program would create greater ultimate value.

As a result of the complexity and difficulty of clearing markets, and then selling advertising across a scattered broadcast pattern, specialist distributors have evolved. Two of the powerhouses in this space, for example, have been King World (now merged with CBS) and Tribune; additionally, given the scale, companies will sometimes further partner with other specialists, as was the case of syndicating *South Park*, where one company was responsible for market clearances and another for the ad sales.

**Barter to the Extreme—Paying for Blocks of Airspace**

*The following is reproduced from the 2nd Edition without modification*

The ultimate barter arrangement is the full auctioning off of airspace. This tends to occur in a couple of niche areas, such as certain children’s programming.

A prime example of this practice was 4Kids Entertainment’s arrangement with Fox. When Fox Family was sold to Disney, Fox opted to shutter its Saturday-morning Fox Kids animation block and instead lease the space. It struck a deal with 4Kids, the company that represented the merchandise licensing rights to *Pokémon* (and certain non-Asian TV rights to both *Pokémon* and *Yu-Gi-Oh!*), where 4Kids paid Fox $25 million per year for the airtime; 4Kids then sold the commercial space within its half-hour block and was betting that either its annual advertising revenue would exceed the $25 million, or if it ran a deficit its merchandising sales would take it
into profits. In essence, the company rented the commercial space, viewing the broadcasts as a giant commercial for the brand that would then drive non-TV revenue. Perhaps only in children’s programming, where robust merchandising programs may be a primary goal, can a producer set a strategy to use the show itself as a loss-leader to drive ancillary revenues. (See Chapter 8 for additional discussion of this 4Kids–Fox deal.)

Infomercials are another area where one sees negative license fees and full purchase of airspace. Here, a company is renting the airtime for a giant commercial. This presents even tougher economics than the 4Kids example, because an infomercial is not selling advertising against the airtime, and therefore needs to recoup 100 percent of the lease costs against product sales. At least in the 4Kids instance, there is the goal for advertising to recoup the rental costs, with the deficit in the worst case merely a fraction of the overall lease costs. For this reason, infomercials tend to air during inexpensive slots, because costs would become prohibitive during prime airtime.

*Impact of Elimination of Fin/Syn Rules and Growth of Cable*

[The following is reproduced from the 2nd Edition without modification]

The huge off-network syndication revenues earned by producers such as Carsey-Warner were among the reasons that broadcast networks started to lobby against the elimination of the financial interest and syndication rules (fin/syn rules). Summarizing the history, the Museum of Broadcast Communications notes:

The Federal Communications Commission (FCC) implemented the rules in 1970, attempting
to increase programming diversity and limit the market control of the three broadcast television networks. The rules prohibited network participation in two related arenas: the financial interest of the television programs they aired beyond first-run exhibition, and the creation of in-house syndication arms, especially in the domestic market. Consent decrees executed by the Justice Department in 1977 solidified the rules, and limited the amount of primetime programming the networks could produce themselves.58

These rules were contested for years, with producers favoring fin/syn fighting the networks, and were eventually relaxed and then fully eliminated in 1995. One of the reasons for the elimination was a belief that media competition, including from the growth of the cable market, had weakened the networks’ prior dominance and that therefore the protections were no longer needed. This was true, to a degree. The combined TV market share for ABC/CBS/NBC in the time of the rules’ promulgation in the 1970s bordered 90 percent, but 20 years later in the mid-1990s the share had dropped into the middle 60 percent. Nevertheless, the fear of vertical integration by major media groups, and the difficulty for smaller producers to deficit finance series in the hope of hits that would pay for misses, remains a challenging reality for independent producers who want to keep the back-end/upside in their productions. How easy do you think it is today for an independent producer to land a show on NBC and maintain ownership in the back-end syndication revenues that could lead to the type of upside reaped by Carsey-Werner on The Cosby Show?

Virtually any producer will lament that the result of changes in the fin/syn rules has been to shift leverage to buyers/networks. I asked Ned Nalle, former president of Universal Worldwide Television and executive producer of various series (e.g., Legend of the Seeker for ABC Studios,
along with Sam Raimi, director of the *Spider-Man* films), if he agreed with this trend. He noted:

Mergers and relaxation of financial interest regulations have led to market concentration. Putting aside whether the quality of the content has improved, deteriorated, or stayed the same since the market contracted, it nevertheless means less competition among buyers for content. That means the leverage pendulum has moved decidedly over to the buyer, and away from the seller. It also seems to excuse that, absent more competitors breathing down his or her neck, a buyer can and will take more time to make a decision. The buyer will also exact more rights away from suppliers. It doesn’t mean that worthy shows won’t get ordered, and eventually be on the air. But shows may be commissioned for financial-interest reasons as much as creative or ratings merits. As the gatekeeper, a network can demand anything from an anxious producer, including distribution rights, financial interest, negative covenants, sequels, spin-offs, and certain protection before a producer might migrate a hit series to a network rival.

**Calculating Number of Runs—Complex Matrix from Multiplex Channels and Exhibition Days**

*The following is reproduced from the 2nd Edition without modification*

The final important element of a pay TV license deal is understanding the implications of increasing runs by the notion of exhibition days and multiplex offerings. In pay TV agreements,
an exhibition day usually is defined in a manner that allows multiple airings of the film within a 24-hour period (similar to the discussion on cable runs, but it was in fact pay TV that established the pattern now being copied). Similar to the cable example previously described, it would be typical to allow a couple of airings within a day. (Note: As discussed below, subscription VOD applications, known as SVOD, are now granting subscribers on-demand access to programs within the pay channel, a trend that obviates the need for exhibition days.) The theory behind exhibition days is that the structure affords the broadcaster greater programming flexibility, offering its customers more choice. For the licensor, because the viewings are confined to within the same day, it is more akin to time-shifting, and as per custom has not raised issues of overexposing the product.

In terms of exposure, an area that needs to be managed is runs on multiplexed channels. Multiplexing is simply the practice of successful services offering expanded channels. Sky in the UK, for example, offers a menu of channels such as Sky Movies 1, Sky Movies 2, and Sky Cinema. Each of these channels will have a slightly different flavor and programming skew, and each of these channels may have other affiliated channels. Language defining an exhibition day will therefore need to take account of the runs within a day and which channels those runs can be taken on. This sum can ultimately lead to a dizzying number of runs.

If we were to assume, for example, that 20 runs are allowed on a primary movie channel, as well as each multiplexed channel, and were further to assume that the total number of multiplexed channels allowed were capped at five, then the total number of runs would be 240. This is calculated as 20 runs per channel × 6 potential channels × 2 runs per exhibition days.

**Deal Term Overview (Pay and Free TV)**

*The following is reproduced from the 2nd Edition without modification*
Although license agreements will obviously be quite detailed, when stripping away many of the legal protections and basic information governing the parties, the fundamental economic structure boils down to a relatively short list of items. While many of these categories have been discussed before, it is useful to view them in a checklist form.

Licensed Channels

In a pay TV deal, defining the range of primary and multiplex channels is critical. While focus may be on runs on a primary channel, there could be several additional multiplex channels (e.g., movie channel versus action channel, or other specialty theme). The multiplex options allow the broadcaster to amortize costs and increase the fees to the licensor; ratings are lower given limited coverage, but exposure may increase significantly. In some cases, there will be formal trade-offs agreed, such that one broadcast on Channel X may be substituted for one or more on Channel Y.

A free TV deal will generally be to a specific identified channel, such as CBS; however, as technology allows multiplexed options such as high-definition channels and even Internet carriage, the notion of a single channel actually existing as a branded channel that may appear in a basket of delivery and sub-branded channels will make this area ever more complex going forward.

Runs

As discussed earlier, pay TV has evolved in a more complex fashion, but with technical
innovations allowing new possibilities with free TV, the concept of “runs” is fast becoming a more complicated issue. In pay TV deals, definitions can become almost ridiculously complex: defining numbers of runs per primary channel, runs per multiplex channel, conversion ratios to exchange runs between channels, aggregate runs on each type of channel (e.g., no more than X on primary and Y on each multiplex), and aggregate runs across the range of channels (e.g., no more than X cumulative runs across all of the licensed channels, including primary Channel X and multiplex Channel Y–Z). When layering on top of this matrix the fact that runs will be linked to exhibition days, which will typically allow two runs per exhibition day, and that exhibition days are defined by time limitations (e.g., a 24-hour period commencing . . .), calculating permitted runs and monitoring runs can become an exhausting and often unclear process. I have been involved in more than one situation where there were valid interpretation debates on permissible runs based on long-standing and seemingly clear definitions—and this all before the notion of viewing via an app.

Term

The structure of a license period can be straightforward, such as a fixed number of years, or complicated if there are multiple windows; a layer of complexity can be added to either scenario when the periods are tied to pending triggers, such as a specified number of months following yet-to-be-announced theatrical or video release dates. Additionally, beyond the actual window, there will often be blackout periods and defined pre-promotional windows.

The above scenarios, even in the case of multiple windows, assume fixed terms with the variable being the start date; however, because rights are bounded by both time and runs, a
license period can, in theory, expire on a fixed or variable date (the variable is the last permitted broadcast). Agreements may therefore often be structured to trigger the end of the term on the earlier of the expiry of the fixed term or the last permitted broadcast/run.

Calendaring software will keep track of this matrix, logging in the fixed date and accelerating availabilities to the extent runs are taken early, which is frequently the case, as licensees will not wait until the last day or even month of a term to exercise broadcast rights. All of this can become more difficult to track if there are multiple windows, which can be similarly triggered by fixed periods or variable dates if tied to the expiry of another right (e.g., following expiry of free broadcast window X). This, in turn, may be likewise triggered by fixed and variable dates.

Taken together, calendaring and monitoring rights availabilities is a complex task subject to errors. The simple question of “availability” can cause lawsuits and relationship issues, as licensees are paying premiums and basing deals on rights that will be compromised if windows are misstated; there is nothing worse than finding that two clients, competitive with each other, both have rights to the same product at the same time. This is a never-ending headache for studios and is an area that is taken for granted, but is fraught with danger if not micromanaged to perfection.

License Fee

This is again straightforward if the fee is flat. However, to the extent there are potential overages involved, or if this otherwise has a contingent element, this can be quite complex. An overage definition needs to account for the difference between the minimum guarantee, which may either be flat or based on cents/dollars multiplied by a minimum stipulated subscriber basis, and the
ultimate fee due, based on the actual number of subscribers multiplied by the agreed cents per
subscriber base. The actual definition can become almost unwieldy in that the “actual” number is
often pegged to the average number of subscribers in a month. The result can be akin to a
complex bank interest calculation statement, with permutations of averages to refine the
calculation.

Rights

The issues here can include:

■ What is the territory? Is it physical- or language-bounded, or both?
■ What languages are included? This may impact the definition of territory, such that rights
may be both territorially and language-bound (e.g., such as a grant of rights for “French-
speaking Belgium”). Further, language can have three tiers: the original version of the film
(e.g., English language), as well as dubbed versions or subtitled versions.
■ What formats/cuts are allowed? For example, will there be one or multiple versions of the
product, such as an original version versus an extended director’s cut, or is the release in
standard definition or high definition?
■ Are the rights just free TV or pay TV, or are there variations such as subscription video-on-
demand (SVOD)?
■ Do the rights licensed extend to channels being rebroadcast or accessed in VOD fashion via
online sites, apps, or wireless systems?
■ Are there technical limitations, such as curtailing digital transmissions?
- Are there carriage/delivery restrictions, such as via cable and satellite?
- Are single or multiple feeds permitted? This issue can arise in a multiplex situation or in territories with remote locations where a relay may be required for coverage in secondary areas.

**History of Growth**

*The following is reproduced from the 2nd Edition without modification*

Unlike the United States, many, if not most, international markets grew up with “state broadcasters.” These were public as opposed to private channels that were either fully owned or controlled by the state, and accordingly funded by taxpayer money. Examples of such channels are the BBC in the UK, ARD/ZDF in Germany, and RAI in Italy. In some of these cases, funding is achieved through television license fees, where all citizens owning a television have to pay an annual TV license fee—a sort of tax. Even though I had been “in the business” for several years, I readily admit to the reality check of receiving my bill when I hooked up my television in London, and realized I was directly taxed to underwrite BBC programming. It is a common notion worldwide, but something of an anathema to Americans who have never experienced this system.

Not only did most countries have public broadcasters, but until the 1990s in many countries these were virtually the only broadcasters. As Americans were getting used to cable and an increasing number of channels, Europeans were just starting to auction off and authorize the first commercial licenses in the territories. In Spain, for example, the state network RTVE had dominated until the government allowed some of the first commercial licenses. The winners and
resulting networks were free-to-air channels Antenne 3, which 10 years later became a leader in exhibiting movies on free TV (such as *The Lord of the Rings* and *Harry Potter* films), and Telecinco (Channel 5); additionally, Canal+ Espagne was initially granted a monopoly in the pay television space. There were, and still are, regional broadcasters, but the virtual simultaneous launch of three new national commercial networks had an obviously profound impact on the marketplace.

In the early 1990s, it was a renaissance for Hollywood studios and networks, for rather than having a handful of buyers limited by public-sector budgets, they all of a sudden had fierce competition from commercially sponsored national networks vying for viewership and profits. The pattern started in Western Europe, and then as the former Soviet bloc led to emerging democracies in Eastern Europe, competition and new stations started to flourish there as well. Hungry for programming, stations signed up massive output deals with studios and networks. Suddenly, the international TV divisions were no longer stepchildren, with hundreds of millions of dollars of revenues (at minimum) per year at stake.

The pattern continues as democracy spreads, broadcast outlets are freed from state control, and economies grow and build larger middle classes (e.g., Eastern Europe, India, Southeast Asia). However, the growth seen a few years ago in certain emerging markets, such as Russia, has slowed and TV distributors can no longer count on greenfield opportunities to substitute for declines in traditional secondary sales. In my second edition, I again turned to Marion Edwards, then president of international TV at Fox, who confirmed:

No market is emerging to equal licensing revenues of the core markets of Europe, and many of the markets considered ‘emerging’ in recent years have peaked and have turned to local
programming to fill their schedules. Because we produce and distribute such a broad range of premium content, we’re able to remain successful and relevant by supplying a variety of films, series, and formats for local production depending upon the mix that a particular territory seeks.

**License Deals (License Deal Terms)**

On the feature side, licenses tend to be for a fixed number of runs over a specified number of years. Also similar to the domestic model, license fees are fixed; on occasion, deals can be indexed to performance, if licensed in an output-deal-type structure. Barter, however, is rarely applied for U.S. product.

Finally, the pattern of packages that often typifies the U.S. syndication market has been frequently applied in the international context. Whether a package is set as part of an output arrangement, or simply as a standalone package, the economic underpinnings are the same. The buyer/station obtains throughput from a key supplier, and the seller has a guaranteed income stream indexed to theatrical performance; as important, the seller has secure placement of its titles, ensuring that underperforming films still find a home. This is a critical fact when circling back to the key value of studios: they are financing and distribution machines, and if they cannot ensure a producer or director that they will maximize revenues and license their films into all markets, then their role is severely compromised. (Note: Output deals apply more often to films than TV shows.)

The following 2007 deal between one of the two major German commercial networks, ProSiebenSat1, and Warner Bros., as described in the *Hollywood Reporter*, typifies this symbiotic relationship:
ProSiebenSat.1 Group . . . has inked a long-term output deal with Warner Bros. International Television Distribution for the free-TV rights to at least 30 films per year, the company announced Thursday. A ProSiebenSat.1 spokeswoman said the deal had a total worth “in the low hundreds of millions” of euros and a term of “several years.”

**Table summarizing countries that started with multiple pay TV networks and then for a period of time consolidated into virtual local monopolies.**

I have not updated this Table (for example to include Moviestar+ in Spain), because with the advent of SVOD and other on-demand services expanding internationally (Amazon, Hulu, Netflix), plus leaders like HBO taking the opportunity to expand internationally, the days of the “pay monopoly” are over and a revised chart would currently be just a snapshot.

International Pay TV Monopolies

<table>
<thead>
<tr>
<th>Territory</th>
<th>Original Pay Services</th>
<th>Current Pay Services</th>
<th>Evolution</th>
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</thead>
<tbody>
<tr>
<td>UK</td>
<td>British Satellite</td>
<td>Sky</td>
<td>Merger of prior two</td>
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<tr>
<td></td>
<td>Broadcasting</td>
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<td>Spain</td>
<td>Canal+ Espagne</td>
<td>Digital+</td>
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<td></td>
<td>Sogecable</td>
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<tr>
<td>Germany</td>
<td>Premiere</td>
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<td>Merger</td>
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<tr>
<td>Country</td>
<td>Satellite Provider 1</td>
<td>Satellite Provider 2</td>
<td>Notes</td>
</tr>
<tr>
<td>---------</td>
<td>----------------------</td>
<td>----------------------</td>
<td>-------</td>
</tr>
<tr>
<td>France*</td>
<td>Canal+</td>
<td>Canal+</td>
<td>Merged in 2006</td>
</tr>
<tr>
<td></td>
<td>TPS</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Orange</td>
<td>Orange Cinema Series</td>
<td>New France Telecom service in 2008</td>
</tr>
<tr>
<td>Italy</td>
<td>Telepiu</td>
<td>Sky Italia</td>
<td>Merger of prior two</td>
</tr>
<tr>
<td></td>
<td>Sky</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Japan</td>
<td>WOWOW</td>
<td>WOWOW</td>
<td>Still competition</td>
</tr>
<tr>
<td></td>
<td>Star Channel</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* There was a growing consolidation of Canal+ and Orange, with Canal+ having acquired France Telecom’s Orange Cinema Series. However, the French competition authority, reviewing the ruling pursuant to which it had earlier authorized the merger of TPS and Canal+ in 2006, said no to this new consolidation and ordered Canal+ (as part of a ruling that allowed Canal+ to take over Bolloré’s free TV channels Direct 8 and Direct Star) to divest its holding of the Orange Cinema Series. The *Hollywood Reporter* described how the head of the French competition authority, Bruno Lasserre, “told French press on Monday that the Canal Plus–Orange Cinema Series deal ‘restricts competition because it made Orange an ally of Canal Plus’ and said that ‘We want Orange to take back its independence.’ The pattern in France demonstrates the natural economic pressures as described for market consolidation, though in this case held back by anti-monopoly legislative enforcement.” It will be interesting to see if this trend is reversed, following the pattern in the UK where the local competition authority decided not to pursue a further investigation of Sky given the increased competition from online services such as Lovefilm (see discussion in Chapter 7).

**Case Study: The Kirch Group**

[The following is reproduced from the 2nd Edition without modification]

Most Americans have not heard of Leo Kirch, even though he was a media mogul on the scale of
a Ted Turner or Rupert Murdoch (well, maybe a mini-Murdoch). Similarly, most Americans
have not heard of KirchMedia or Betafilm, but the Kirch Group’s production reach spanned the
globe and was behind the scenes of some of the more well-known shows—everything from the
*Gone with the Wind* sequel *Scarlet*, to *Baywatch*, to *Star Trek* spin-off series (e.g., *Star Trek: The
Next Generation*), to *JAG*, to coproducing/financing in Europe *The Young Indiana Jones
Chronicles*.

What Leo Kirch achieved was total vertical integration in the German marketplace across TV
stations, supply of TV product, and local production. At its height, the Kirch Empire, worth
billions of dollars, was akin to wrapping NBC, HBO, Disney merchandising, and the largest
local production company under one umbrella.

On the network side, Kirch built and controlled two of the three largest national free
television commercial broadcasters: Sat 1 and ProSieben. On the pay television side, the group
built the dominant pay television network, which, after a few iterations, is now known as
Premiere. What was remarkable about the Kirch Empire is that Germany is highly decentralized
and to gain national licenses it was necessary to gain buy-in from each of the autonomous
regional areas. This was not wholly dissimilar to Fox aggregating enough local independent
stations to form a national network. The difference in Germany is that when Kirch first built
these networks, there were no other comparable national commercial networks: they were, in
essence, creating the first commercial competition to the public broadcasters.

To feed the programming needs of the stations, and grow them, Kirch virtually monopolized
the supply of programming from the United States. Early on, Kirch lobbied the U.S. studios,
even bringing the regional stations they were trying to aggregate to meet people such as Frank
Wells at Disney (at the time, co-head of Disney with Michael Eisner). Ultimately, they
succeeded, and secured long-term output deals with all the major American studios. In a bold stroke, they created a duopoly. The only viable place for U.S. studios to license their product for top value became Kirch. In turn, Kirch had a monopoly on the programming put on its controlled networks. The result was a vertically integrated media empire that, for a period, controlled the television landscape in the country.

Over time, the Kirch Group built up one of the world’s greatest libraries and largest integrated media companies in the world. An online encyclopedia summarized that:

By 1993, Kirch Gruppe had become the largest entertainment program provider for German-speaking countries, including Switzerland and Austria. The group was involved in all areas of the movie and TV entertainment business, such as production, synchronization, distribution, rights and licensing trade, movie and video rental, and merchandising. Besides owning about 15,000 movies and 50,000 hours of TV shows, Kirch’s many production firms put out about 400 hours of new movies and TV programs per year.61

In addition to building a library of owned and licensed titles, the Kirch group built state-of-the-art technical facilities to store and archive the vast product accumulated. The technical group and storage vault at BetaTechnik became world-renowned, and many international producers used the facility to store negatives, prints, and masters, as well as to create foreign-language versions. The BetaTechnik storage vault looks like a scene from a sci-fi movie, with tall rows of film prints in a secure, clean, climate-controlled room reaching stories high, and mechanical computerized robots able to pull and access individual elements. When U.S. studios and leading producers wanted to archive treasured masters and prints, despite local options and promises of
salt mines able to withstand nuclear strikes, many ultimately turned to Leo Kirch. If you want to find the old reels of a classic film, your best bet is not Hollywood, but Munich.

Like so many entertainment company stories, however, the reign of Betafilm and Kirch ultimately came to an end. KirchMedia’s bankruptcy was nothing short of spectacular, with far-reaching consequences across borders. The *Hollywood Reporter* chronicled: “KirchMedia’s bankruptcy in April 2002 was the largest in German post World War II history. Before it fell, the company built by Bavarian mogul Leo Kirch had the largest library of films and TV rights outside the U.S. studios . . . Observers estimate that when Kirch went belly up, the company’s bad debts totaled €10 billion ($13 billion).” The impact of the bankruptcy sent ripple effects through an incredible array of high-profile businesses and even governments:

- The banking world: HypoVereinsbank, Germany’s second-largest publicly traded bank, and Bayerishe Landesbank (owned 50 percent by the Bavarian government) combined had loaned Kirch well over $1 billion.
- Kirch had employed over 10,000 people.
- Kirch held the rights to Formula One racing, and some worried it could destabilize the entire sport.
- Kirch held the broadcast rights to the German soccer league (and the worldwide broadcast rights to the World Cup), and missed payments could have thrown the sport into turmoil.
- It became a political issue, in that the Bavarian premiere Edmund Stoiber was the opponent in 2002 to Chancellor Gerhard Shroeder’s re-election; speaking of the Bayerishe Landesbank’s $1.7 billion in outstanding loans, *Time* magazine quoted Shroeder as saying: “This is not an indication of economic competence, but the opposite . . .”
Kirch owned more than a one-third share in Germany’s largest publisher, Axel Springer Verlag.

There are many reputed causes, but two facts were, at minimum, catalytic forces. First, in an effort to build a digital pay service, Kirch tried to reproduce the strategy that had been so successful in free television: lock up rights. The difference was that by the late 1990s, the international markets had matured, studios had grown shrewder (and perhaps greedy), and the costs had ballooned. In 1996, for example, a 10-year deal with Paramount was announced for $1 billion. Unfortunately, the field-of-dreams thinking did not lead to subscribers rushing to the service. Pay TV subscriptions did not come close to estimates, and the service, as described by *Time*, was losing money fast: “Kirch managed to sign up 2.4 million subscribers; the break-even point was 4 million. The company was losing more than $2 million a day and he borrowed heavily to keep it running.”

Second, Kirch acquired the distribution rights to Formula One, another investment reportedly in the billions. This acquisition was targeted, in part, to gain monopoly-broadcasting control of the sport to drive viewers to its channels. A second and more controversial theory was that the group was also working to rescue EM.TV, a company that had a somewhat symbiotic relationship with the Kirch family of companies. Animation producer and distributor EM.TV was founded by a former Kirch executive, Thomas Haffa, and had a meteoric rise in value. Germany had never had a small market cap exchange such as the NASDAQ in the United States, and in the heyday of the Internet had launched a new exchange, appropriately called the Neur Markt. EM.TV was the star of the Neur Markt, going public, as described by *Business Week*, on revenues of only about $15 million and soon seeing its stock rise to into the multibillions:
EM.TV & Merchandising, a Munich outfit that may well be Europe’s hottest company. EM.TV had a tiny $15 million in annual sales when it went public in October 1997. But over the past 10 months it has grown at an explosive rate as Haffa has spun deal after deal with the biggest players in the world of entertainment, from Walt Disney Co. to German media titan Leo Kirch. Its stock is up around 10,000 percent, to nearly $1,000 on Germany’s growth stock exchange, the Neuer Markt. The stock carries a price-earnings ratio of roughly 90; Merrill Lynch & Co. estimates the company will earn $38.3 million this year on sales of $117 million.66

Part of its success was directly tied to Kirch, as EM.TV formed a venture and programming block called “Junior,” which gave EM.TV the exclusive rights to Kirch’s entire 20,000-title library of animated titles; for its part, Kirch helped land programming on its stations, guaranteeing distribution for the titles. EM.TV then leveraged this base with the fortunate circumstance that few, if any, major German media companies had ever been available to the public for investment; the two local giants, Bertlesman and Kirch, were both closely held private family companies.

EM.TV used its stock market value to go on an acquisition binge, first buying or acquiring investments in smaller animation studios, and then nabbing a big fish with the purchase of the Jim Henson Company. In a story on the cover of Business Week titled “The Cartoon King,” Thomas Haffa boasted that they would rival Disney, and securing the prized Henson company was almost a metaphorical move to prove its ambition.67 Several years before, after the death of Jim Henson, a pending acquisition of Henson by Disney fell apart in a public spat and now,
nearly a decade later, the Germans had won the day. Of course, there was an enormous price: the reported sales price was $680 million, a figure that many insiders considered a significant premium over other market offers. (Note: In an odd twist of fate, EM.TV ultimately sold Henson back to the Henson family (for a fraction of what it paid), who then turned around and sold the company to Disney, completing an odyssey that had the Muppets initially and then again in the Disney family of brands.)

The next deal was the straw that broke the camel’s back. EM.TV, which up to that point had been a company focused on children’s programming and drew strength from its merchandising abilities, diversified to acquire controlling interest in the sport of Formula One racing. In October 2000, EM.TV came under fire for irregularities in the reporting of earnings tied to the Henson acquisition, and the stock price crashed 32 percent in two days, and then shortly fell to less than one-third of its 52-week high. (Note: As another aside to the story, the German Neuer Markt, which had been based on the NASDAQ, eventually went out of business; although I have not seen it written about, EM.TV had been a significant percentage of the market’s overall capitalization (e.g., several percent), and the failure of EM.TV started the spiral that led to the downfall of the whole market! Imagine a U.S. bankruptcy that actually helped take down the whole stock market and you can glean the enormity of the Kirch and EM.TV saga.)

The Formula One acquisition did not stem the tide of the digital pay services losses, however, and the collective weight of debt eventually put the once-dominant company into bankruptcy. Perhaps in a move to gain scale as global media partners were growing and perhaps to raise capital, given the slow subscriber growth (partially attributed to an expensive set-top box
digital decoder), Kirch started offering small stakes in his empire for the first time; Silvio Berlusconi’s Mediaset in Italy, Rupert Murdoch’s NewsCorp, and German publisher Axel Springer all took small shares or had put options. When Axel Springer exercised its put option worth $670 million, and then Murdoch followed, the company, as described by Business Week, collapsed:

What went wrong? Everything, say industry execs and ex-Kirch employees. The set-top decoder cost $500, and Kirch stubbornly tried to pass the cost onto subscribers . . .

Underlying pay TV’s woes were the huge sums Kirch paid for rights to films and sporting events. His deals with foreign media companies obligated him to pay some $2.6 billion for films through 2006, West LB estimates. Vivendi is just one of the companies embroiled in litigation as it seeks to collect some $200 million from Kirch. Industry insiders believe he owes Paramount $100 million . . . Most important, Kirch had a 45-year history of borrowing big, betting big, and winning big. It was hard to imagine he would fail.70

(Note: At the time, Vivendi was the parent to Universal and Canal+.)

Within a few short years, both Kirch and EM.TV were reduced to shells of their former selves and the heyday of Germany as the key territory financing Hollywood television came to an abrupt end. The country, though, still remains one of the strongest TV markets. ProSiebenSat1, previously consolidated by Kirch (ProSieben had been founded by his son Thomas), was acquired by Israeli Power Rangers mogul and Fox Kids founder/co-owner Haim Saban. Saban, cash rich from the sale of Fox Family to Disney (since rebranded as ABC Family), cleverly bought during the tough days following the dual crashes of the Internet and Kirch, and
in just a few years turned the network around and sold the group at the end of 2006 for more than $7.5 billion, a multiple of the purchase price.71

I have included this detailed background to illustrate a few salient points about the international television market. First, it is large. Once a stepchild of Hollywood, individual countries now have the scale to compete on a level playing field with the United States. Betafilm and Kirch produced and acquired quality programming in a quantity that rivaled any U.S. group. (Note: Betafilm today is once again a major producer/distributor.) Second, the market dynamics are no different than those found in the United States. Fierce competition for programming and eyeballs on networks leads to enormous risk-taking. Third, all Hollywood studios had deals with Kirch, gaining significant cash flow they could count on against production budgets. Fourth, the international TV market is a perfect example of the world economy. In the case of Kirch, a German company became a global media player that fueled and supported the cash flow of multiple Hollywood studios and producers. It acquired the TV rights to the second-most-watched sport in the world, and ultimately sold its leading network in bankruptcy to an Israeli-born entrepreneur (Haim Saban) who made his fortune on kids’ and animated programming in the United States (having leveraged the fortune from Mighty Morphin Power Rangers into the building and sale of Fox Family). For Saban, his timing and navigation of the kids’ programming space outwitted EM.TV. In the end, somehow, most of the key children’s assets (the Muppets and Fox Family), ended up with Disney.

**TiVo and DVRs**

*[The following has been reproduced from the 2nd Edition without modification]*
First, there was TiVo, a revolutionary technology that allowed the pausing of live television. The essence of TiVo was that the technology converted a television into an easy, better, and virtually idiot-proof VCR—but not just a VCR that recorded shows, a type of digital recorder that allowed viewers to manipulate television shows as if they were being played via a VCR. Soon, the technology became more common, with cable companies such as Comcast offering bundled recorders with its service. The functionality initially enabled by the TiVo brand gave way in an OEM world to generic versions labeled digital video recorders (DVRs).

TiVo had the first-mover advantage in terms of digital recording technology, and in addition to being able to pause live TV and record programs for playback with VCR functionality, the storage capacity enabled viewers to record a season of programs with the press of one button (record all episodes in the season of X). People that used TiVo became quickly addicted, but by 2005 the upstart Silicon Valley-based company was facing fierce competition from cable providers offering copycat DVR services. In particular, large cable providers such as Comcast aggressively marketed like-services at competitive prices with the marketing advantage of upgrading a captive installed base of customers. (Note: Comcast and TiVo then struck a deal to offer customers TiVo, meaning specific TiVo interface features.) As earlier discussed, the adoption of DVRs and resulting change in viewing patterns had such a profound impact that it led to a fundamental change in measuring ratings (Live +).

What is a bit hard to fathom is how quickly today new technologies lose their competitive advantage and simply become a commoditized feature set in digital devices. Today, the pausing feature of Tivo is a consumer expectation in any hardware (or even software) capable of exploiting the function. Of course, this is an area rife for patent claims, as evidenced by Apple’s ire over features in Android smartphones.
CHAPTER SEVEN: Internet Streaming and On Demand Access: A New Paradigm

Matures - On-Demand and Multi-Screen Access, FAANGs+, Cord-Cutting, Online

Originals, Cloud Applications, Social Media, Changing How We Watch, Direct from the Creator, and More

[The following materials have been reproduced from the 2nd Edition without modification]

The Explosion of Video on the Web

By the mid-2000’s, everyone was predicting a revolution in the world of video content and how programming would be consumed over the Internet as opposed to traditional television viewing. At the World Economic Forum in Davos, Switzerland, Bill Gates proclaimed: “I’m stunned how people aren’t seeing that with TV, in five years from now, people will laugh at what we’ve had.”

Wired magazine, in an article that also asked how a couple of students “make their way through the 5 billion-channel online universe to you,” spoke of the changed dynamic in nothing short of revolutionary terms:

Online video has arrived ... Thanks to growing bandwidth, easy access to the means of production, and cheap storage, it’s exploding all around us and becoming a very real, very different way to experience news and entertainment ... What’s happening here isn’t just TV online. Gone are the rigid 30- and 60-minute blocks; now the clip is it — be it 30 seconds or eight minutes, we’re watching only the money shots. Gone is top-down broadcasting; instead, the network has been, well, networked, with thousands of creators and places to watch ... And gone, too, is the at-this-time, at-this-channel programming; now, we’re not only time-shifting with DVRs, we’re space-shifting as well, watching stuff on our laptops,
iPods, and cell phones — even loading it back onto our TVs ... What’s on? Whatever you want. 73

By this point in time there was an explosion of experiments, with networks, studios, Internet companies, and start-ups trying to stake out sections of the new frontier. At the same time all of the following were taking shape:

- New points of access for video were emerging (Internet, phones, hand-held)
- New applications of offline revenue models were being adapted (e.g., VOD, advertising supported)
- Convergence between Internet access and the TV started to feel real
- DRM solutions were enabling both streaming and digital downloads
- Delivery solutions were evolving (e.g., streaming, peer-to-peer)

The variety of offerings tempting consumers — from portability to living room convergence, from rental to ownership, from free to paid-for content — was dizzying and confusing. And yet, as we now know, these disruptive changes from 2006-2008 were just the tip of the iceberg.

**Speed and Quality as Limitations to Adoption and Downloads**

A limiting factor to download adoption has been the immaturity and historically slow speed of the delivery mechanism. Films and TV shows are dense graphic files, and the download speed is still relatively slow (especially when compared, for example, to the time to download a song or even full album). The total file for a film is in the range of 1 gigabyte of data, and yet
even over a broadband connection the download time is closer to 1 megabyte/second. At over 90 minutes of content, the total download time of a film can still exceed an hour, and for a long film can be closer to an hour and a half (e.g., a movie needs about 1 gigabyte of hard-drive space and can take less than an hour to download via a high-speed Internet line\textsuperscript{74}). The pure inconvenience of this lengthy download is a clear inhibiting factor, and the competitive advantage of peer-to-peer systems able to break content into scattered bits accelerating downloads is a key factor that stimulated pirate services; however, despite comparatively slow downloads the market continues to grow. In theory, as download times decrease, and the population downloading content increases, this market should accelerate. However, while it was originally assumed electronic downloads would be the substitutional avenue for sell thru, today it is unclear what the balance will be given the growing adoption rate for subscription streaming and the evolution of cloud based digital lockers. A few years ago I would not have questioned the inevitable growth of downloads, but ubiquitous VOD and remote unlimited storage over time could obviate the desire for downloads and in fact eliminate the market (except for limited downloads to create resident copies for use when travelling or in other situations where Internet access is unreliable or unavailable). No longer are people postulating that downloads alone will cannibalize other windows and become the dominant method of acquiring content.

Further, the growth of downloads is now no longer dependent on the speed by which the ultimate end monitor for viewing experiences converge. Currently, Internet downloads tend to be stored on computer hard drives, and the resulting film watched over computer monitors or portable devices. While monitors have been steadily improving, the experience is still vastly inferior to watching over a good TV set (this is being enhanced rapidly with the growing market penetration of flat screen sets). Moreover, the sound quality of watching via a computer is
arguably a worse experience relative to viewing over a home theater system than is the
differential in visuals from the PC screen to the big living room set/monitor. Nevertheless, the
introduction and mass market adoption of tablets has dispelled these theories—a tablet screen is
clearly good enough for most people (even if a flat screen TV is better), and if your TV monitor
can call up content on a VOD basis or connect to your portable device via an HDMI cable (or
wirelessly), then neither experience is tethered to downloads.

To DRM or Not to DRM

While DRM systems were responsible for giving studios comfort to release content in
digital form, there are many that argue DRM is both contrary to the open nature of the Web and
an inhibitor of adoption. Different hardware systems with different DRM technology create the
potential for a whole new version of format wars. These are more complicated than the historical
video market battles because there are multiple competing versions. The music industry
struggled with DRM issues for years, and in January 2009 the record labels and Apple struck a
new deal: the music industry abandoned its insistence on DRM and Apple agreed on flexible
pricing (moving off the $0.99/song structure and allowing labels to differentiate pricing and
charge premiums for new and/or hit songs). Consumers were arguably ecstatic, as the knock on
DRM had been the inability to move libraries from one system to another, thereby locking a
consumer into its portable storage device and limiting flexibility in terms of download sites and
devices (ironically, making portable media to a large degree non-portable).

The same dilemma faces the Hollywood studios over video content and, with DRM often
perceived as synonymous with copyright protection, simply allowing free access is not a favored
solution regardless of the music industry’s stance. One suggestion has been an industry registry,
a kind of clearing house where consumers can register their device. Movies and TV shows
downloaded from different registered sites could then be matched and played on any device similarly registered by a manufacturer. If one believes in the historical trends, then it is likely that over time DRM controls will be relaxed and, whether via a registry or not, a more fluid and open system will mature. Nevertheless, that new system has to presuppose adequate security protections enabling the monetization of content; while the relaxation of DRM restrictions for music was enabled in part by the relatively secure and closed iTunes ecosystem, video has evolved into a hodgepodge of sales, access, and distribution points where each distributor needs assurance that users will have to pay for their content. Namely, content providers and distributors want to restrict their concerns to how to tier those fees (sooner, later, limited, forever), not whether they will get paid at all. Accordingly, a new security industry is growing, implementing DRM systems (e.g., Microsoft’s PlayReady, Google’s Widevine) with third party specialists (e.g., Irdeto) adding additional encryption and security layers to bolster protections for the most highly prized content offerings.

Déjà vu –Internet Piracy Control Measures Reminiscent of Fear of Perfect DVD Copies

A key technological advance inherent to controlling piracy, as well as essential to managing the delivery of and access to content via the Internet, was the improvement in encryption systems. History is repeating itself, with the prior fear that DVDs provided perfect digital copies that could be pirated holding back the introduction of DVDs. This was overcome both by market forces and the perceived sense that DVDs were not so easy to copy. Now that DVD recorders are more prevalent, and the safeguards have proven to restrict rampant copying of films, the fear has dissipated not because there is a perfect preventative mechanism in place but because the market has grown so large that naysayers have been marginalized. It is amazing
what short-term memory and large revenues can do to both theory and well-grounded concerns.

Now the same issues are surfacing with the Internet, and the same scenario is playing out with the added complexity of authenticating specific devices and users. Licensors are anxious about their jewels being placed on someone’s hard drive (or sharable device), and all the implications that go with that loss of control. Yes, the files are encrypted to ensure that your copy is truly on the end of a digital yo-yo, with the distributing service able to pull the strings to cut off the copy, pull it back after a set amount of time, and virtually control its ability to be played and copied (despite the fact it is stored on your computer, and now also on your tablet and in the cloud).

All of this is critically important in the short term, but to many less important downstream where they question the feasibility of imposing these levels of controls on consumers—assuming threshold levels of DRM and security protection can preserve essential windows. Just as with DVDs, once this market matures it will become increasingly difficult to exercise the micromanagement controls over individual copies that are now exercised. Users will be able to break loose of many shackles, but the hurdles will be hard enough, and legitimate use (hopefully) will become custom enough that most users will follow the rules and the percentage of those people violating the protocol will be containable. Once this level of maturity takes place, the violators of the platform will be relegated to the same basket as DVD pirates: a serious threat that needs to be managed, but hopefully not a category killer. Additionally, distributors hope that the ease of cloud-based storage systems, where users can access their content when and where they want (including via device of choice) will further mitigate piracy. In this new iteration user or device authentication becomes the new gating concern; hopefully password sharing type piracy schemes will not flourish in a manner tempting pirates to provide free cloud access akin to the battles fought in the Pay TV industry where hackers break encryption and offer free or cut-
rate access to otherwise paid subscription services.

**Common Platform — Behind the Scenes Accelerant**

Not much seems to have been written about this factor, but simplicity and common platforms have been essential to the areas of explosive growth of accessing and viewing video content via the Web. The case of iPods is well documented in the download space, but what beyond the concept of YouTube led to the exponential growth of streaming video? Other companies, such as iFilm, had been around for years with similar aspirations, but were leapfrogged by YouTube. Why? Arguably, part of the answer was the compelling nature of YouTube coupled with both mass market high-speed Internet adoption (whether by DSL or cable) and use of common browser-based players. In the Web 1.0 days there were “player wars” with Real Player, Windows Media Player, and Apple’s QuickTime fighting to become the de facto standard. As video on the Web grew, spurred by YouTube’s rise, Macromedia’s Flash player seemed to gain dominance, with most users seamlessly adopting newer improved versions (e.g., Flash 7) to watch online video. Flash was becoming standard, and while companies routinely transcoded source material fewer were actively supporting multiple platforms—until, of course, a few years later Steve Jobs denigrated Flash and famously introduced the iPad without any ability to play/support flash files (Apple continuing its strategy of scoffing at the notion of common platforms and instead innovating a closed, and what it perceives as superior, integrated ecosystem).

**A Landscape Changed Virtually Overnight by iPods**
Given the more recent launches and phenomenal success of the iPhone and the iPad, it is easy to forget how revolutionary the iPod was for video. Although Apple did not break down statistics within the video category, or even what number of video-capable iPods were sold relative to all iPod purchases, it did confirm the following facts following the product’s 2005 launch: (1) there were 1 million video downloads in the first month, (2) there were 8 million video downloads in the fourth quarter 2005 post launch, and (3) there were upwards of 4 million video downloads in the first month of 2006. By September 2006 the Hollywood Reporter quoted Steve Jobs boasting: “In less than one year we’ve grown from offering just five TV shows to offering over 220 TV shows, and we hope to do the same with movies … iTunes is selling over 1 million videos a week, and we hope to match this with movies in less than a year.”

This adoption rate is staggering when compared to the growth, for example, of Netflix, which was the most successful Internet-based method of acquiring video content to date before the iPod (though Netflix was not a download service, but a hybrid using Internet ordering like Amazon to then ship physical goods [rental DVDs] via the mail). Netflix took roughly 3 years to reach its first million subscribers, and another couple of years to reach 3 million (admittedly, not an apples to apples comparison given downloads vs. subscribers). Further, the iPod adoption rate was remarkable given the relatively limited amount of content available. While the iPod for music launched with a catalog of thousands of songs (and to the consumer, a catalog of content crossing the spectrum of virtually all labels, genres, and major artists), the iVideo application launched with a handful of TV shows, including ABC hits Lost and Desperate Housewives, and shorts from Pixar. (Note: It was this cooperation between Apple and Disney, with Desperate Housewives being the top property available to launch the iVideo application, that was among the factors turning the much played out saga of the Disney–Pixar
distribution negotiations back onto a positive track, before ultimately quickly shifting direction and leading to the January 2006 announcement of the $7B+ acquisition of Pixar by Disney. Digital distribution was for real, Steve Jobs was perceived as the industry’s guru, and in one stroke Disney regained its animation market preeminence as well as gained Jobs as a key shareholder and board member to help steer them into the digital future.) Not surprisingly, competitors rushed to the market, and the era of on-the-go video was launched, even though the smart phone and tablet markets which we view today as commonplace had not even been invented. It is a testament to the pace of technology, especially as it relates to video-based content, that in my first edition I could focus on how the iPod had revolutionized the market, and that less than five years later the video iPod as a standalone device is no longer a driver of digital viewing.

**Confluence of Factors Initially Ushering In Media’s Digital Revolution**

*The following is reproduced from the 2nd Edition without modification*

The confluence of several factors ushered in the digital revolution that threatened to upset and cannibalize traditional TV and video distribution:

- the “Googlization” of the world and proving the Web can be monetized;
- the YouTube and (prior) Hulu generation, instant streaming, and the emergence of free video-on-demand (VOD);
the enabling of mobile and app viewing, starting with the introduction of the video iPod and then the iPhone;

■ implementation of reliable, flexible digital rights management (DRM) technology;

■ traditional distributors, not pirates, legally making the market;

■ Netflix pioneering the SVOD market, and introducing binge-watching disrupting longstanding viewing norms;

■ mass-market penetration of high-speed Internet access (fixed and wireless).

**Fear Factor I: Panic to Avoid the Fate of the Music Industry (including threat of piracy from peer-to-peer services and importance of DRMs)**

[The following is reproduced from the 2nd Edition without, in most instances, modification]

The quick pace of change and related murky legal waters initially cast fear among traditional distributors that the lifeblood of their business may be snatched away before they could even respond (with some arguing via illegal means). The crisis in the music industry, which was first paralyzed by online piracy and then rescued, in part, by iTunes, was threatening to similarly upend visual media as peer-to-peer services enabled file sharing of movies. Long-form video content, which previously had been thought to be somewhat immune given the inherent barriers of hour-plus stories and correspondingly large file sizes (i.e., a film cannot be divided into independent consumptive elements, like a record can be split into songs) was suddenly vulnerable. Whether melodramatic or not, the fate of media was perceived to be in the balance—and to many it still is.
While there are no fully reliable statistics on illegal downloads versus legal buys, most industry insiders would admit that legal watching is simply a fraction of overall Internet viewing. At first, there was a proliferation of illegal services, and the motion picture industry, like the music industry before, had to contend with how to convert people to pay for something they were quickly becoming accustomed to receiving for free. The biggest danger came from peer-to-peer services that could virally distribute thousands of copies of a film almost instantly.

The threat of piracy, and the impact of the new breed of peer-to-peer services, was dealt with in 2005 by the U.S. Supreme Court decision in *Metro-Goldwyn-Mayer v. Grokster*; this case, discussed in Chapter 2, was a turning point for how Internet piracy would be perceived and contained. For here, it is simply worth reiterating that the peer-to-peer file-sharing services, such as Grokster, Kazaa, and BitTorrent, enabled individual users to efficiently share and download movies and other video content for free. There was enormous pressure, both at the government and industry level, to nip this in the bud and avoid a crisis similar to that experienced by the music industry prior to the white knight arrival of iPod and iPod lookalikes. Additionally, because the Web knows no geographic boundaries, it has become equally critical for foreign jurisdictions to act similarly. The Swedish Court’s 2009 jailing of individuals behind Pirate Bay—a notorious site thumbing its nose at the notion of copyright protection—and the FBI’s shutting down of Megaupload, paired with the indictment of its founder Kim Dotcom, bolstered the trend fought for in Grokster.

A key technological advance inherent to controlling piracy, as well as essential to managing the delivery of and access to content via the Internet, was the improvement in encryption systems. History is repeating itself: the prior fear was that DVDs provided perfect digital copies that could be pirated (holding back the introduction of DVDs), and now the same issues are
surfacing via digital versions distributed through the Internet, with the scenario complicated by the need to authenticate specific devices and users. Licensors are anxious about their jewels being placed on someone’s hard drive (or shareable device), and all the implications that go with that loss of control. Yes, the files are encrypted to ensure that your copy is truly on the end of a digital yo-yo, with the distributing service able to pull the strings to cut off the copy, pull it back after a set amount of time, and virtually control its ability to be played and copied (despite the fact it is stored on your computer, and now also on your tablet and in the cloud). All of this is critically important in the short term, but to many it is less important downstream, where they question the feasibility of imposing these levels of controls on consumers. To the extent people break the rules, services are shoring up safeguards and facilitating a path to market maturity where violators will hopefully be contained and be relegated to the same danger level as DVD pirates: a serious threat to be managed, but hopefully not a category killer (see further discussion in this companion website).

Finally, coming back to the urgency of thwarting peer-to-peer-enabled piracy, exacerbating the need for the studios to act and restore a sense of equilibrium, was the fact that change was taking place on the heels of the decline and peril experienced by the music industry. There was a feeling that this stage of change was somehow fundamentally different than prior iterative technological advances (which, despite previous fears, had served to expand total revenues); moreover, there was a realization that without action, the historical safety nets could not be counted on to preserve current markets.

Because everyone was unsure whether online would be an ancillary market or instead be the whale that could swallow the whole, as well as where lines should be drawn concerning viral access, people were scared and tending to take absolutist positions. With no obvious solutions,
unproven monetization, different metrics than traditionally employed, fear of piracy, conflict between protecting valuable windows versus leveraging the Web’s consumer marketing reach, and unprecedented adoption rates (e.g., YouTube, Facebook), media conglomerates at once acknowledged the changes were real and struggled to craft solutions that would expand rather than shrink the revenue pie.

_Fear Factor II: Would On-Demand and Download Markets be Less than Substitutional for Traditional Markets (Pessimistically Discounting the Potential of the Markets Being Addictive)?_

[Includes: “The Explosion of Video on the Web,” “Change Could Have Been Even Faster (Speed and Quality as Limitations to Adoption and Downloads),” “To DRM or not to DRM,” “Déjà Vu—Internet Piracy Control Measures Reminiscent of Fear of Perfect DVD Copies,” “Common Platform—Behind The Scenes Accelerant,” and “A Landscape Changed Virtually Overnight by iPods.”]

[The following is reprinted from the 2nd Edition without modification]

No matter what hype, until the on-demand and download markets approach revenue levels of the video market, they still represent secondary revenue streams. Video-on-demand is already perceived as the video of the future, and advertising-supported VOD (AVOD)/FVOD will be a critical element of TV going forward (see Hulu discussion on page 377, 2nd Edition), but the associated revenues from each remain a small fraction of the larger markets; moreover, it is not certain which markets will actually converge (is SVOD the same as pay TV?), nor whether different access methods will be complementary or whole segments will be eliminated. This is a critical issue given the Ulin’s Rule factors outlined throughout: historically, licensing content
through windows fostering exclusivity, repeat consumption, variable timing, and price points has optimized the pie. Because VOD can largely fulfill the consumer’s appetite for access to all “when I want it, how I want it, where I want it,” there was a simultaneous attack on not just the concept of windows, but more fundamentally the elements of exclusivity and timing upon which windows are constructed.

Economically, one of the key factors underlying this jeopardy is straightforward: online trends toward nonexclusive access, and TV licensing in particular is premised on exclusive windows. The much-hyped long tail of the Internet affords a broader platform for access to library titles than has ever existed before, but the long tail does not inherently prove enhanced monetization of that content. (Note: Most content people want to see already finds a home via traditional media (e.g., *Brady Bunch* reruns on Nick@Nite); see also discussion of marginalized return of the long tail in Chapters 1 and 6.) The jury is out. Even if access to a program and consumption dramatically expands, that would still not ensure greater licensed revenues than could be achieved from competition over exclusive rights. The threat presented by online is that expanded access and consumption could, for the first time, actually shrink the pie if that expansion is enabled by free and non-exclusive access. If windows are not choreographed and controlled but content is instead subject to the free-for-all of the Web, then many fear the bar will be lowered. Moreover, lower distribution costs, given the elimination of physical goods, does not guarantee higher margins, given the downward pricing pressures online.

In summary, the safety net that new technology would expand revenues—as had repeatedly happened, such as when video did not cannibalize TV, as early pundits feared—was in jeopardy, and executives in various sectors were left with the challenge of inventing a new market and revenue models or else, as in television, watch their repeat licensing revenues fall in the face of
earlier online access that did not make up for their losses. Although people were witnessing a revolution of how programming would be consumed over the Internet as opposed to traditional TV, few were as prescient about the scope and speed as Bill Gates. At the 2007 World Economic Forum in Davos, Switzerland, he proclaimed: “I’m stunned how people aren’t seeing that with TV, in five years from now, people will laugh at what we’ve had.”

New markets and models have indeed emerged (e.g., catch-up via Hulu, subscription streaming via Netflix), giving hope that at least a balance can be restored. It is still too early to declare whether such new models will ultimately be additive. What is abundantly clear, though, is that consumers will demand multi-platform access, with repeat consumption in the future meaning consuming content via a smartphone, game console, PC, tablet, Internet-enabled TV, OTT hardware box, Blu-ray player, etc., in a pattern dictated more by convenience than a distributor-crafted linear sequence.

**Hulu’s AVOD Roots and Transition to Subscription Offering**

This entire shift in strategy for Hulu evidences just how quickly the space is evolving. Remember, it was not that long ago that it pioneered free streaming catch-up television by leveraging content from network partners and then innovating online syndication access together with new advertising models. Moreover, that structure and service was quickly a big hit: only roughly six months after launch, Hulu could boast providing 142 million streams to 12 million unique visitors, making it, according to Nielsen Online, the “sixth-most-popular online video brand in the United States, surpassing online video networks operated by ESPN, CNN, MTV, and Disney.” By spring 2009, roughly a year post launch, it had leapfrogged the competition to become, according to Nielsen Media Research, the number-two most popular video streaming site behind only YouTube. Further, Hulu pioneered distribution by embracing distribution
partnerships, providing embed codes to enable users to show programming within their own sites and thus allowing the programming to virally circulate. Hulu accordingly pioneered the practice of enabling third-party websites to embed players into their sites, a practice now accepted as common, but at its inception it was considered a radical model and led to over 6,000 websites distributing Hulu content when only in the beta test phase. [Note: this was a significant departure for the network owners (Fox and NBC, and now also ABC), who thrive on driving viewers to a distinct location.]

Further, at the time of my second edition Hulu was thriving with a hybrid coupling its new subscription service with hits advertising supported model. At the time, I asked David Baron, Hulu’s VP of content partnerships, why, with the success of free streaming (the AVOD service), it made sense to branch out with a subscription service and how Hulu+ differs from the basic free service. He advised:

Hulu+ provides a number of advantages in the marketplace over our basic AVOD service. For consumers, there may be additional content that is not available on the free service, as well as expanded access. While you can only watch the free Hulu service on PCs, Hulu Plus is accessible via a range of connected devices, including game systems, set-top boxes, smartphones, tablets, and connected TVs. Hulu+ also creates a dual revenue stream, with more revenue available to the content owners, which we believe is ultimately a better model for the industry. We’ve generated over $1 billion for our content providers since our founding, and today more of this money is coming from our dual-revenue-stream subscription service. Given these benefits to the consumer and content provider alike, we
think we have a great runway ahead of us—as our advertising business expands, our programming diversifies, and our subscriber base continues to grow.

**Amazon Historical Rules (From Amazon Instant Video)**

*[The following is reproduced from the 2nd Edition without modification]*

It is instructive to look deeper at Amazon’s rules, which provide a kind of guide to the new distribution order. For example, in the Amazon Instant Video Usage Rules found under “Videos” on Kindle Fire tablets, the company spells out that for streaming content, “You may stream purchased videos online through your Web browser and through Kindle Fire, compatible Internet-connected TVs, Blu-ray players, set-top-boxes that are compatible with Amazon Instant Video.” Cognizant of the ever-expanding access points, and wanting to be ubiquitously available (competing for the same reach as competitors such as Netflix and Hulu+), Amazon is at once pushing its captive platform (Kindle Fire) while expanding its competitive reach. Then one needs to look at the restrictions tied to renting and owning. If one owns (i.e., Purchased Videos), then the access is infinite, either streaming from Your Library or launching a download, Amazon noting that viewing periods are “Indefinite—you may watch and rewatch your purchased videos as often as you want and as long as you want (subject to the limitations described in the Amazon Instant Video Terms of Use).”

Not surprisingly, rental is more complicated, as DRM protocols and other usage rules will attach to these more transient rights. For example, while only being able to download the content to one device, there is some flexibility in porting content with a Kindle, as you can start watching
a download on your Kindle Fire and then finish streaming it via a different compatible device (so long as it is not simultaneously playing on multiple devices). When I first looked up the usage rules under Amazon Instant Video Terms of Use, there was an almost Freudian slip indicative of the complexity of implementing DRM—the posted rules noted of playing on not “more than once device.” Viewing periods in rental are, not surprisingly, bounded (as restrictions will be set in the licenses with content suppliers), with restrictions on the macro-window of how long you have to start your rental post paying (e.g., 30 days) and how long you have to complete watching once you have started (e.g., 24 or 48 hours).

Finally, the third leg of the Amazon viewing stool is Prime Instant Videos, permitting Amazon Prime members—where a Prime membership costs $79 per year and affords members free two-day shipping on all e-commerce orders highlighted as eligible for Prime, plus unlimited instant streaming of movies and TV shows made available under Prime Instant Videos—the ability to watch content without any window restrictions (other than the content being available to Prime members). Amazon Prime Video is thus a kind of free-subscription-streaming-on-demand service akin to free video rental, provided as a value-added benefit to its Prime members. Given that Prime membership was originally, and remains primarily, an e-commerce financing option (pay $79 and get unlimited two-day service, where customers have to estimate the break-even on shipping costs and their yearly orders), granting quicker delivery to eligible products, Amazon is cleverly leveraging and cross-marketing to its customer base to build user traffic for its Instant Video service. Once hooked, an Amazon convert who has a Kindle Fire will see the holistic benefits of flexibility: ability to stream or download a video instantly upon purchase, and to enjoy the currently boundless storage of a remote digital locker or freedom of a resident copy should the manner of his or her on-the-go viewing be at a time when he or she may
not have Internet connectivity.

The entire value proposition is highly compelling, and yet while this adds value to Amazon as well as the consumer, how will this fungibility play into the longer-term profitability of the producer/content supplier? The ability to so easily “watch and rewatch,” as Amazon states, is no doubt fantastic for the consumer, but the ease of repeat consumption undermines that particular monetization driver (even if ownership has always enabled, the portable and remote flexibility reduces the chance of paid-for repeat consumption/need for multiple copies) and access via so many devices punctuates a measure of nonexclusivity (undermining part of the exclusivity driver, even if only here tied to Amazon). A content supplier previously would salivate at the segmentation of re-consumption and types of devices, which would create additional monetization opportunities tied to the additional consumption. All the while, though, this ease of consumption for viewers is not accompanied by higher or even any additional fees—the only extra money being made is from the hardware device manufacturers or content access points/platforms (e.g., www.amazon.com, Kindle Fire store). Moreover, Amazon is able to loss-lead its hardware, given its customer base, provide quasi-free subscriptions to undercut the value being paid for other subscription streaming services (e.g., Netflix), and influence consumption choices through its recommendation engines. In a nutshell, Amazon’s offerings highlight the conundrum faced by content suppliers today, unable to turn a blind eye to what consumers crave, yet unable to capture new revenues in as profitable and efficient a manner as they have historically driven through the value drivers sustaining traditional windows.

**Growth of the App Economy—Access via Tablets and Smartphones**

*The following is reproduced from 2nd Edition without modification*
An entire book could be written about the explosion of the app economy and the phenomenon of tablets, and I do not plan to delve into the history and specifics of each of these categories. Nevertheless, a discussion of media access and distribution would not be complete without noting the impact.

The whole notion of “apps” was created when Apple launched its App Store in 2008, dramatically expanding the functionality of the iPhone—a classic example of utilizing software to drive hardware sales, though in this example profits flourished in tandem. The market adoption was nothing short of extraordinary, both in terms of companies leveraging the opportunity to develop apps, launching everything from new content to new businesses. Only nine months after the store’s launch, Apple’s SVP of worldwide product marketing announced in a press release: “The revolutionary App Store has been a phenomenal hit with iPhone and iPod touch users around the world, and we’d like to thank our customers and developers for helping us achieve the astonishing milestone of one billion apps downloaded.”

By the start of 2013, in another press release, Apple recounted the following new milestones:

- Customers have downloaded over 40 billion apps, including nearly 20 billion in 2012 alone.
- The App Store has over 500 million active accounts.
- The third-party developer community have created more than 775,000 apps across the iPhone, iPad, and iPod touch.
- Since inception of the App Store, developers have been paid over $7 billion by Apple.
- The game Temple Run from Imangi Studios was downloaded more than 75 million times on the iOS platform in 2012.
Two emerging game developers (Backflip Studios and Supercell) brought in more than $100 million in 2012 across their freemium titles DragonVale and Clash of Clans.\textsuperscript{87}

The market pioneered by Apple soon saw copycats, just as happened with the iPhone (and with it, not surprisingly, a flurry of patent lawsuits). Soon there were apps tied to the Android operating system, and the market had become big enough on its own that categories of job definitions and statistics were being renamed to take account of apps, and Apple’s CEO Tim Cook boasted of mobile apps that “Apple has become a jobs platform.”\textsuperscript{88} In terms of job growth, the \textit{New York Times} noted: “A study commissioned by the tech advocacy group TechNet found that the ‘app economy’—including Apple, Facebook, Google’s Android, and other app platforms—was responsible, directly and indirectly, for 466,000 jobs. The study used a methodology that searched online help-wanted ads.”\textsuperscript{89} Regardless of whether you believe the detailed statistics, there was no doubt that the notion of an app economy had become real. Even with Apple taking a 30 percent share on app sales, developers could profit handsomely, and stories were emerging of programmers creating games and other apps making them virtually overnight millionaires. (Note: Such stories are always the PR draw, and those earning this type of money are obviously a small fraction of developers.) As discussed in various chapters (including Chapters 6 and 9 regarding TV distribution and marketing), the growth of the market enabled an entirely new category of marketing and cross promotion, and with the near-simultaneous rise of social media, distributors found an entirely new avenue beyond websites to both promote and distribute content (e.g., HBO Go, Facebook pages accessible via Facebook app).

Tablet growth spurred further adoption and convergence, as Samsung (Galaxy), Amazon
(Kindle Fire), Barnes & Noble (Nook), Microsoft (Surface), and a host of other major consumer electronics companies (e.g., Lenovo, Toshiba) entered the market. As noted above, it is now likely that by the printing of this book, tablet shipments will exceed those of notebook computers—in a remarkably short period, app access via tablets has become mainstream, almost ensuring that the consumption and distribution vehicle will remain, even if the particular enabling hardware devices evolve or are superseded by some form of new technology in the future.

Although I am mentioning apps generally under the category of cord-cutting and alternate access, it is important to clarify that while apps enable portable access, they are what networks and cable operators hope will be an antidote to cord-cutting; as described in Chapter 6, TV networks are tying apps to subscriptions, so that if, for example, you subscribe to HBO, you can access that content off-network via the HBO Go app. This fulfils consumer demand for flexibility, but as discussed in other chapters, it does not necessarily satisfy the consumer that wants à la carte access to a hit show and does not want to pay for the bundled full subscription. This is where I have argued that there is no entitlement to access, and those that want PPV à la carte access early cannot, by fiat, change a window (and model) that has been designed to create cash flow to finance risky productions in the first place. Whether the ability of apps to offer easy PPV and VOD access is so tempting that it forces window changes (or else overwhelming demand will cause piracy to compromise the market) is still evolving, and different providers are experimenting with timing and tiers (see also, discussion below regarding international leaders leveraging apps). Apps, therefore, like many of the other Internet or digital changes, create another conundrum for distributors who see tremendous advantages (such as flexibility and a mechanism to blunt the effect of cord-cutting) and yet must tiptoe around the complications the
new ecosystem breeds (e.g., should producers/networks tied to paid subscription models, where hit programs drive lifeblood subscription revenues, create a new form of windowing or access to leverage growing PPV demand?).

**Features Pioneered by Sky**

*The following is reproduced from the 2nd Edition without modification*

An interesting fact regarding the “everywhere” multi-screen concept is that before it became in vogue in the U.S., international companies were already pioneering the trend. In particular, Sky in the UK (a division of NewsCorp) had launched Sky Anytime (which later was rebranded Sky Player), which, as discussed in Chapter 6, enabled content to be both pushed and pulled to a box, and leveraged the satellite infrastructure of the Sky network. By the time the U.S. cable carriers announced their TV Everywhere ambitions, Sky had again rebranded as Sky Go and was now pioneering delivery leveraging the new app construct. With the Sky Go app, subscribers to the Sky service could now access content via games systems (e.g., Xbox), mobile phones, PCs, and tablets. Moreover, Sky started to migrate the bundle of cable packages into the Sky Go ecosystem, where content access was tiered to corresponding subscription levels. For example, a variety of live TV channels is offered, but not all channels may be available via the simple Sky Go app, and broader Sky subscription packages may be required. To ensure the widest adoption, Sky Go, for example, is also available for non-Sky TV subscribers on a PPV basis.

Because Sky has always been one of the global pioneers in terms of pay TV—adapting to new platforms, and broadcasting overall—I turned to Sophie Turner-Laing, its managing director
of content, and longtime Sky executive, and asked: (1) whether embracing the multi-screen world and making the Sky app accessible via a range of devices, from game systems to phones and tablets, if the viewer base is expanding and thus bringing in more revenue, or if the old base is just being segmented; and (2) whether non-subscribers should be able to access key pay TV content on an à la carte PPV basis, as to some this takes away a carrot to growing and keeping the subscriber base. She advised how the app was indeed proving additive, and why enabling new tiers/types of access should not be viewed as a threat, but rather how Sky is opening up new distribution opportunities:

Sky’s position as a market-leader is down to the way it combines the best possible content with cutting-edge technology that enhances the viewing experience and makes it easy for customers to watch TV on their terms. Our mobile service, Sky Go, is a great example of that. It’s attracting over 3 million unique users a quarter, and growing, and we’re continuing to expand the content available and extending it to reach more devices. New services like Sky Go offer even more value to existing customers from their subscription, but they also provide another reason for people to join Sky and help us to grow our overall customer base. We also recognize that we can monetize this success, which is why we have launched a new subscription service, Sky Go Extra. For a small additional charge, customers have the ability to download TV shows and movies to view offline and they can register two additional devices for Sky Go. It’s still early days, but we’re excited about this opportunity.

We see the growth in new forms of distribution as an opportunity rather than a threat. As well as enabling us to add greater value for existing customers, it also allows us to reach a
whole new group of customers. That’s why we launched our own Internet TV service, NOW TV, which is available via a wide range of connected devices. Customers can currently buy a monthly pass to watch Sky Movies. The next step will be the launch of Sky Sports this Spring, with customers able to buy day passes that offer access to all six Sky Sports channels for 24 hours. We believe that the launch of Sky Sports on NOW TV is an exciting opportunity. This is a way for us to reach new customers by bringing a whole host of sports to an even bigger audience. Developing NOW TV alongside our market-leading Sky service positions our business well to deliver for customers and enjoy future success.

Ways to watch on the go

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[From Sky website]
Limited Historical Studio Attempts to Make the Download Market

[The following is reproduced from the 2nd Edition without modification]

Recognizing the potential of the market and the need to have legitimate platforms to counteract piracy around the onset of the online video explosion, the studios launched their own Web-based download services. The largest was MovieLink, a service co-owned by the following consortium of studios: Sony, Universal, MGM, Paramount, and Warner. A competitive service, CinemaNow, also offered a range of studio product.

While pioneers in providing a legal option for movie downloading, neither of these services—both hampered at the time by slow download speeds and starting up during the heyday of the peer-to-peer services that were eventually shut down by the Grokster decision—caught on, and adoption remained limited. Whether the problem was functionality, piracy, pricing, or available content does not matter, as part of the early strategy was for the studios to simply show they were offering a legal alternative to pirate peer-to-peer sites. In the end, with the platform showing increased promise and piracy curtailed, MovieLink was acquired by Blockbuster in the summer of 2007 to provide its download solution.90

Physical Retailers Offering Competitive Online Solutions

The challenges in the media space are no different for physical retailers trying to craft digital solutions than in other areas of retail. Namely, the woes of the traditional book store or record
store are no different than toy stores or travel agencies, except perhaps a bit more acute; this is because media properties, often being intangibles (intellectual property), lend themselves uniquely well to digitization and digital consumption. A virtual tire will not do much for your real-world flat, but a portable, indestructible, comparably or lower-priced digital version of a TV show will not only be substitutional, but in the eyes of many consumers a preferable product option. Coupling this real world to digital conundrum of suppliers with the fact that their e-tail competitors (e.g., Amazon, Google/YouTube, Netflix) are some of the stars of the Internet (that have also redefined the world of logistics), it is a daunting challenge—and one that they are more often than not losing. In some instances, the only way companies have found to compete is to acquire companies as a market entry hedge against the inevitable erosion of their traditional businesses.

Walmart provides a telling case study. Recognizing the peak of the sell-through video market (see Chapter 5) and the corresponding threat to its lucrative (and market-leading) DVD business, in late 2006 Walmart introduced its own download service. The guinea pig title was Warner’s Superman Returns, as Variety summarized:

Deal allows Walmart customers to download the film for use on portable devices for $1.95, computers for $2.95, or both for $3.95, in addition to the cost of the DVD, which retails in Walmart stores for $14.87. The retailing behemoth, which accounts for 40 percent of DVD sales, said it hopes to expand the pricing model to other titles . . . Deal marks Walmart’s attempt to convert its enormous walk-in DVD customer base into download films.91

This launch and hodgepodge pricing was symptomatic of the confusion in the market—the
pricing model was clunky compared to the simplicity of all songs for $0.99 (the iTunes pricing then in effect). What the retailers were doing was trying to add comparable value (“we have it too”) as opposed to something revolutionary. Clearly, the studios were taking a cautious approach. Discussing the fine line between online adoption and maintaining a vibrant DVD business at retail, Jeffrey Katzenberg, CEO of DreamWorks Animation, was quoted in the *Wall Street Journal* as saying: “We must not undercut our bread and butter . . . The consumer decided when VHS was obsolete . . . Not the hardware manufacturers, not retail, not us.”92 The same article that quoted Katzenberg went on to describe the awkward position both Walmart and studios found themselves in, and the retailer’s reluctant entry into the digital market as highlighted by its dilemma with Disney: “After Disney announced a deal to provide television shows to Apple’s video iPod, Walmart threatened not to carry the DVD version of the hit Disney Channel movie *High School Musical*, according to people familiar with the situation. After talking it through, Walmart ultimately relented and carried the DVD in its stores.”93

Capability to offer downloads is one thing, but turning the new business to profitability is another. Walmart was entering the same murky waters of its competitors, hedging its bets against the future. Like everyone else, they would have to wait and see whether the new revenue streams would be additive or substitutional for its traditional business. Walmart, it seemed, quickly made up its mind: not much more than a year after it struggled with Disney and launched digital distribution, Walmart abandoned its experiment. The reasons for its abandonment were likely manifold, but one interesting point sometimes referenced is its DRM requirements were tied to playing content via Windows Media Player. This factor essentially precluded content from being watched on iPods, the then hardware platform of choice for watching downloaded content.94

Fast-forward to 2010 when Walmart re-entered the market with its acquisition of Vudu,
beating out competitors such as Blockbuster for a reported price tag of more than $100 million.95 Vudu, at the time a Silicon Valley start-up, began as a set-top box manufacturer; for the reasons discussed above (and counter to the strategy of some of the OTT device manufacturers discussed above that went fully in the other direction), namely the challenge of connecting yet another box to the TV and recognizing the migration of building the technology into TV sets and other connected devices as an app, Vudu shuttered its hardware box and integrated its cloud-based service with leading consumer electronics manufacturers such as Samsung, Toshiba, and Vizio. By Christmas 2011, Vudu included its VOD service into gaming systems (Xbox 360 and PlayStation 3) and tablets, placing it alongside the likes of Netflix and Amazon on the panoply of devices pioneering the OTT market. Additionally, Vudu added the flexibility to either rent (e.g., $0.99) content or download, and marketed availability of titles as the same day as DVD (since, for windowing, it positioned itself as an on-demand online rental outlet, not offering subscriptions, even marketing Vudu as same day versus Netflix DVD being 28 days later).

We are still in trial stages of companies working to leverage their online versus offline user base, but some initiatives for the 2011 holiday shopping season began to illustrate the type of cross-promotional campaigns that may become marketing staples. Walmart offered a $5 Vudu credit to buyers of certain DVD and Blu-ray titles (e.g., Megamind) in its retail outlets, leveraging in-store traffic over Black Friday.96 GameStop, the leading independent games retail chain, had earlier pioneered programs such as this (and has a strategic advantage through user registrations tied to game exchanges and the robust online market), and it was accordingly not a surprise. What will be interesting is whether these key retailers continue to utilize different branding in their offline versus online presence (GameStop versus Impulse, Walmart and Vudu). The answer may be more in the consumer awareness of the brand itself—Netflix’s attempt to
separate its businesses and utilize different branding (i.e., the 2011 Qwikster debacle) did not work, while Walmart was likely aware of its prior failures and different customer bases and kept the unrelated Vudu moniker for its online presence.

**AVOD Takes Off**

*The following is reproduced from the 2nd Edition without modification*

Hulu successfully pioneered an AVOD model leveraging network content; namely, TV shows and other premium content were available for free streaming, with revenues earned through the sale of video ads. As discussed in Chapter 6, Hulu believes “less is more,” and grew serving a few video advertisements per 30-minute episode, in contrast to nearly eight minutes of advertising typically cut into a network commercial half hour. By restricting advertising and prohibiting ad-skipping, the service can charge a premium per ad, as well as offer a more compelling viewing experience. Not only are there fewer ads, but a unique feature debuted by Hulu is allowing viewers to select among advertising options before a program rolls (e.g., electing to watch a longer pre-roll advertisement, such as two minutes before the program starts, rather than have the show interrupted with a couple of shorter advertisements spaced interstitially).
In retrospect, looking at the historical growth of YouTube (free), coupled with ever-increasing broadband penetration and the growth of WiFi access, it was only a matter of time before professional content supported by free advertising mushroomed into a large TV-like business. Video advertising, with its short content and higher value, could be easily streamed, making what was already the standard for advertising offline the optimum form of advertising online—but even better, given the ability to target streams. Hulu was arguably the first and most compelling service to leverage this new paradigm, coupling free advertising with on-demand access.

Looking beyond its success to date, though, Hulu’s AVOD monetization challenge is a microcosm of the overall challenge of the Internet with content: How can services blend the value of equal streams over diffuse locations (see next section) and time versus the live effect of television? Namely, how much are 10 million viewings in “syndication” worth versus live?
In my last edition, I asked David Barron, VP of content partnerships for Hulu, what he thought about the comparison to TV syndication and what Hulu was doing differently that was making it successful in monetizing the new space. He advised:

To compare what Hulu is doing to TV syndication, you first have to understand that TV syndication is just one of many windows in the lifespan of a piece of content. Traditional entertainment companies have always relied on windowing content, whether by platform, time, technology, territory, etc. Hulu is proving that there is another viable window of free on-demand that can live alongside other distribution windows such as TV and electronic sell-through. For current network programming, the on-demand period extends for some number of weeks post initial TV airing, thereby extending the period viewers can watch their favorite show. For library content, the new on-demand window allows people to discover programs that either haven’t been available for a long time, or weren’t available in their market, and therefore provides a new revenue stream for the content producer. Of course, these are all businesses in development, and therefore the rules are changing regularly.

In terms of how Hulu may be better exploiting this opportunity, including the long tail of library product, we create a great environment for people to enjoy long-form premium video, and whereas others have focused on user-generated content or, in cases, quantity over setting a quality bar, Hulu recognizes that entertainment is impulse-driven and we want to make it very easy to watch high-quality premium content in an equally high-quality environment.

[The following is reproduced from the 2nd Edition without modification]

Types of Internet Advertisements and Relative Value

Among the many types of online advertisements, the oldest and most common are banner ads,
which are bought and programmed in standard pixel sizes. For example, there may be rectangles (e.g., the ubiquitous 300 x 250 unit) or a vertical box on the side of a page (a “skyscraper” ad).

With the advent of video content there has been a corresponding growth of video advertising. It is assumed that just as with television, a video commercial will be more compelling than a static banner advertisement. Given the nature of the Internet, including the trend for content to be delivered in shorter segments, video ads often come in short increments such as 15 seconds (though there are certainly 30-second and longer spots as well). More important than length, though, is placement. Where such advertisements are placed may be more critical online than with respect to TV because of the shorter Internet attention span and tendency for users to move on quickly (taking the concept of channel surfing to a new level); accordingly, services continue experimenting to try and ascertain what mix of pre-roll, interstitial, or post-roll advertising optimizes viewing and therefore monetization.

All of these factors can affect value. Advertising is priced on a CPM model (cost per thousand eyeballs), with CPM rate cards differentiated by type and placement of commercials. For banner advertisements CPMs are much lower (such as $1+ or less) than for video ads (which can command CPMs of several dollars, even > $40), and because a viewer is more likely to watch an ad before a piece of video than stay and watch one afterwards, the rates tend to be higher for so-called pre-roll ads than post-roll ones. The highest CPMs are achieved with “relevancy” and advertising from behavioural networking sites that can serve targeted advertisements based upon knowledge of a user’s preferences and interests. These networks will aggregate sites or otherwise gain access to users’ preferences, and will interpolate that if you have visited an auto site recently then it may make sense to serve you a car related advertisement (even though this is being served to you on a non-auto related site). In a sense, these networks are taking an Amazon-
type recommendation engine to the next extreme, matching what it knows about you not to what you may want to read next but rather by imposing advertisements on you to entice you to buy, read, visit, etc., something next.

The methodology of capturing engagement can also vary, with the historical valuation method linked to traffic. Traffic, however, can be differentiated by impressions and unique users. Advertising rates (such as banners) tied to impressions are a less exact measurement of a user’s engagement than tracking what that user did, what exactly they watched, how long they watched, and whether their viewing then led to another activity (such as a related purchase, where conversion percentages are tracked). If what the user does (conversion ratio) is the critical value, such as in a search engine where people buying advertising care about users clicking through to their site via their advertisement (consuming or even making a purchase), then a cost-per-click model will likely be utilized. As the metrics improve and advertisers become more savvy, the media buys are being more closely crafted to pay out on actual results.

**Exclusions: Frequency Caps and Out of Market Traffic**

Among the early changes (~2007) as the advertising market matured was the imposition of frequency caps. This means that if an advertisement (such as a banner) was served to a specific user who came to the site, then that impression was counted in the traffic to calculate the CPM and resultant payment; however, the frequency cap meant that the site could only count that user once or twice, for example, in a period of 24 hours. Accordingly, for a site dependent on repeat visits from a loyal base, it became harder to monetize because most and in some cases all repeat visits were excluded from the economic calculations.

Beyond frequency caps, the more advertisers can directly correlate traffic to specific demographics for their brand/product the more they will seek to link payment obligations to
specific delivery to a target user. Originally, international visitors were bundled into traffic numbers utilized for monetization purposes, but over the last few years it has become more accepted to exclude international numbers from the impressions counted. [Note: for media this has become less of an issue as sites increasingly geofilter] For some sites, by backing out international visitors (who are not impacted by an advertisement for a local product or event) and applying frequency caps the impact could seriously erode its monetizable base.

**Cost Side: Cost of Goods is Lower, but not Zero**

All of the previous discussion deals with the revenue side of the advertising equation, but revenue splits are increasingly based on net advertising revenues. Because there are few physical costs, margins are extremely high; there are, nevertheless, some costs. First, ads need to be hosted and served to a site; this is invariably a third-party function given the need to cycle through ads and the nature of placing advertisements at Internet speed. One of the leaders in this space, DoubleClick, was purchased by Google, and like all competitors in this space charges a fee per advertisement served (usually a very low fee, but makes its money on volume). In addition to the costs of serving and hosting, it is not unusual for yet another third party to actually program and insert advertisements, as well as report metrics back to the advertisers. An advertising buy may guarantee a dollar commitment, but it will usually be based upon certain delivery of impressions; accordingly, this service will not only program the advertising, but report back to the advertiser whether the site playing the ad delivered the requisite impressions (and then may cycle out the ad once it has met targets). Similar to the hosting and serving company, the provider of this service will tend to charge a fixed fee (again, very low, with profits made on volume) per advertisement.

**Available Inventory**
The final element in the advertising matrix is inventory, and who is authorized to program what, and when. Everyone wants to “sell out” their available inventory of space at the highest CPM rates, but in practice just like other media (e.g., TV) there are higher and lower performing sections of sites — a fact exacerbated by many sites being hundreds of pages deep. A site owner’s goal is to maximize sell out, and also maximize the value of key real estate. Key real estate may be the home page, and for video-based content may be the landing pages for the content, and the pages/areas surrounding the player through which the video is seen. To sort through this maze, a site’s ad/sales department will work to set up a waterfall of options, frequently contracting with multiple third-party advertising sales companies and networks. One party may have the right to sell video advertising inventory, and another banner advertisements. Similarly, one party may have the first right to sell a space, but it may then default to someone else if either inventory remains or they have not secured advertising for inventory X with minimum established CPM thresholds. At the bottom of the waterfall will be “network” or other advertising which carries a lower CPM, but can be placed to fill remaining inventory (often referred to as remnant inventory). If space still remains then the site may elect not to include advertising or to run “house ads” cross-promoting its products and services (and certain amounts of space may be reserved for house advertisements in premium sections for promotion in the same manner that TV networks run commercials to promote their own shows).

One of the key challenges for any site is trying to incorporate inventory space without turning off users. When I was managing starwars.com, this was an issue I always considered, and all managers of visual-based sites to some degree struggle with striking a balance appropriate to their brand. Content Web sites range from a purist vision to Coney Island commercialization, and every site needs to find its right proportion. What a good designer can enable, though, is
increased inventory in a non-intrusive way, with the dynamics of how many ads can be incorporated within prime real estate potentially the tipping point for profitability.

Figure 7.7 summarizes the continuum of values and how the P&L works:

![Continuum of Values/P&L Diagram]

**Revenue**
- Banner Ads
- Video Ads
- Targeted Advertising
- Sponsorship

*Increasing CPM*

Minus

**Expenses**
- Ad Serving & Hosting
- Reporting
- Programming & Insertion

= Net Advertising Revenue

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**2nd Edition Figure 7.7 Continuum of Values/P&L**

**The Emergence of YouTube and its Acquisition by Google**

*The following is reproduced from the 2nd Edition without modification*

Digital technology accelerates adoption rates so dramatically (see discussion of scaling and joint ventures in Chapter 1), that usage outpaces the rules of the road, which still need to evolve to address the new landscape. This is happening now in the context of Facebook and social networks as regards privacy. When YouTube took off, the issue was posting content owned by a third party, and what was considered copyright infringement. To put this in context, it is important to take a step back and frame the success and impact of YouTube.

At the same time that iPods were fueling the adoption of downloads, free streaming video
services led by YouTube were experiencing exponential growth and consumer acceptance.

Figure 7.9 [2nd Edition] is the growth curve for YouTube, exhibiting at the time unprecedented growth from startup phase to over 80 million users per month in a 2–3 year period.

In fact, the growth was so rapid (again, at the time, as opposed to the new benchmarks set by Facebook, Twitter, Tencent, etc.), and YouTube had catapulted so far ahead of its competitors, that it was acquired by Google for $1.65 billion in October 2006—an enormous deal, given that YouTube was reputedly losing money. The Hollywood Reporter quoted Ken August, principal at Deloitte Consulting, commenting on this dynamic: “It’s a huge price for a company that isn’t profitable . . . It’s a reflection in general of the huge interest in video on the Internet.”

In fact, the deal was reminiscent of the high-flying deals of the dot-com days before the first bubble burst in 2000, as the move was driven by traffic—where Google’s own Google Video lagged behind—with the assumption that monetization would follow.

Not only was this deal risky, given the money paid for a company that was reputedly not yet profitable, but YouTube carried litigation risks. Certain videos on the site were from content companies that viewed the site as infringing its copyrights, and were requesting YouTube to “take down” the material. This remedy, in theory, would insulate YouTube from copyright infringement liability under the Digital Millennium Copyright Act (see also Chapter 2).
A mitigating factor argued by Google/YouTube was the promise of implementing filtering technology. While significant progress had been made in “audio fingerprinting technology,” which would compare music to catalogs of copyrighted songs and enable the automated identification of infringing material that could then be taken down, progress on implementing a video system was lagging. Tensions and stakes were thus extraordinarily high, and a Universal Music spokesman commented in the *International Herald Tribune* on companies’ actions to prospectively cure the problem and ignore the past: “The copyright law doesn’t give people the right to engage in the massive infringement of our content to build a thriving business and then, after the fact, avoid exposure by saying they will prospectively start to filter . . .”

Although it was not clear whether YouTube would be weighed down by the type of copyright infringement problems that led to the demise of Grokster and other peer-to-peer sites,
there was a significant difference in this context. Google/YouTube was not a pirate and pledged to clean things up. It was viewed as the type of player that could legitimize the market, much like Apple had done in the music space, and developing and implementing filtering technology was, at minimum, an effort to take a best-practices approach. In fact, YouTube not only made good on its pledge of implementing filtering technology, but also innovated what it calls its “Content ID” system. Utilizing this tool, any publisher has the right to tag its content to identify its authenticity. [For how it works, go to Help on Google support or YouTube under Content ID; for example, click on the copyright notice on the YouTube home page and it will bring you to the following link: https://www.youtube.com/yt/about/copyright/#support-and-troubleshooting]

Viacom versus Google/YouTube

Perhaps it was inevitable given the high stakes of distribution, the Hollywood-produced copyrighted programs appearing on YouTube, and Google’s seemingly overnight leap to market leader that a nasty fight would erupt. In March 2007, just months after Google’s acquisition of YouTube, Viacom sued Google for $1 billion. The amount itself was a statement, but the suit alleging “massive intentional copyright infringement” was a serious counter-punch to failed negotiations over the uploading of clips to YouTube from popular Viacom shows. Instantly, the case was cast as battleground central for old versus new media; moreover, the suit promised to be the seminal case in the evolution of copyright law, following the Sony Betamax case and *MGM v. Grokster* (see also Chapter 2). In the end, as discussed in Chapter 2, the U.S. District Court in 2010 sided with Google, ruling on summary judgement that YouTube was protected by the “safe harbor” provisions of the Digital
Millennium Copyright Act, shielding it against copyright claims by its implementation of take-down provisions to remove infringing materials when put on notice. Although Viacom is appealing, most view the summary judgment as a clear ruling. The ire of the studios (or at least of Paramount/Viacom) is evident in a comment after the verdict from Viacom’s general counsel Michael Fricklas: “YouTube and Google stole hundreds of thousands of video clips from artists and content creators, including Viacom, building a substantial business that was sold for billions of dollars . . . We believe that should not be allowed by law or common sense.”

Marketing Benefits: The Elephant in the Room and the Studio Dilemma

One of the oddities of the tug-of-war playing out in debates around what content users may permissibly upload is that while studio and network executives deride online sources that enable the playing of their content without permission, a large number of executives—and often from the same companies—advocate utilizing highly trafficked online sites for marketing. To the distribution boss, a clip or episode played without permission is taking money away while, to the marketing boss, the exposure of content to tens of millions of people with a viral effect is driving awareness and interest. Harmonizing the positions, however, is far from simple, and continues to present a conundrum.

I turned again to former president of Universal Worldwide TV and independent producer Ned Nalle and asked him how he viewed the marketing benefit compared to the risks. He sees a substantial turnaround from a few years ago when providers were more negative, lamenting that “no producer is getting rich off Internet delivery of his series,” broadband was perceived as siphoning viewers away from traditional broadcasters, and advertisers were underpaying because
of the immaturity of the system (and inability to reliably measure viewing):

The convenience of Internet content delivery offers producers several advantages: the first is free marketing. Audiences can sample a debutante series on the bus, in flight, at lunch; not just at home. Positive experience on their portable screens can impel new devotees to the broadcast or cable channel that airs new episodes of that show at a regularly scheduled time.

More importantly, broadband delivery advantageously enables a transfer of power from the broadcaster to the viewer. Binge viewing, which made a weekend event phenomenon from catch-up viewing on network series such as 24 and Lost, now becomes the great product attribute of video-on-demand.

Many thought Netflix would thrive or fail delivering movies. But much of that service’s recent value proposition was bolstered less by films, but instead because it granted instant consumer access to full seasons of TV series episodes. Were Netflix ever rebranded as “Nettube,” the new moniker would be justified as on-demand streamed delivery of multiple seasons of a television series extends the subscriber’s commitment to that branded service (as well as competitors like Amazon Prime Instant Video, HBO Go, Showtime On-Demand, Hulu+, YouTube, Vudu, etc.) Series streaming enable enables viewers to catch up and gorge themselves on an entire cannon of episodes (e.g., Vampire Diaries, Downtown Abbey, Game of Thrones, Homeland, The Following, Revolution), with total disregard to when network programmers decide to schedule or cancel the series. Even with some delayed availability, once each episode becomes streamable, the privilege of subscription empowers the viewer to seize control from the network schedulers.

For the streaming service, the customer engagement for compelling TV series far outlives
a single movie. For intellectual property owners, consumer access replenishes coffers. Subscribers pay the streaming company, who in turn compensate the copyright holder. Producers no longer reach ends-of-product life cycle when their serials (such as the examples above) don’t repeat well in a second broadcast run. For years, there was a good reason why local TV stations didn’t pay up for rerun rights to serialized dramas. With story outcomes known, serials didn’t rate. But this old model assumed a paradigm of weekly or daily scheduling at a specific time of night, where the viewer is beholden to the scheduler. Currently, second-run serials seem to find new purpose when programmed back to back by a viewer with a remote-control device. Missed plot points are easily recovered by scanning backwards. When the CW Network sought salvage value in its serial reruns in 2011, Netflix came to its garage sale, flush with subscriber cash.

Streaming services delivered by the Internet, and pay TV channels that originally entered the home from satellite or cable, are not dissimilar. Like HBO and Showtime before them, streaming channels have begun to finance exclusive content (e.g, Netflix’s early offering, *House of Cards*) at sizeable license fees. Regardless of delivery method, in Netflix, YouTube, Amazon Prime, and others, content producers have found additional, rich customers for dream projects. More customers are usually welcomed by any business.

Brief discussion of some of the Guild’s early positions, and how the issue even prompted calls for an entire overhaul of the residual system

*[The following is reproduced from the 2nd Edition without, in most instances, modification]*
When streaming revenues first promised to grow, associated revenue from digital exploitation (both streaming and downloads) become a critical topic in the overall compensation of talent. Members of Hollywood guilds remembered conceding issues and participation in the early days of video, not recognizing what an important element those revenues would become for film and television properties. The fear of “never again” has driven entrenched bargaining positions, and served as the emotional lightning rod for negotiations between the WGA and SAG with the Alliance of Motion Picture & Television Producers (AMPTP). It is fair to say, haggling over digital revenues will now be a mainstay of union negotiations for the foreseeable future.

Essentially, even though online and downloadable revenues are still relatively small today compared to sums historically generated via traditional outlets, actors, writers, and directors all want to protect themselves as these revenues grow—especially if they grow rapidly and start to cannibalize the monies that they have fought so hard to protect in past guild agreements.

To read about the issues in the press, it is easy to think that everything is unfair, and residuals are the lifeblood of compensation. In fact, [as discussed in Chapter 2 of the 1st Edition regarding the compensation of writers], it is important to recognize that residuals (and what is fought over in guild new media negotiations) represent just one element of the overall compensation pie, and in many cases a relatively small fraction of the total compensation an individual will earn with respect to a particular project. While securing fair compensation for reuses and ensuring that digital media exploitation does not undermine revenue streams previously fought for has obvious logic, this is arguably an area where emotion and perceptions of just compensation play disproportionately to the actual compensation at hand.
Does Abandoning the Historical Residual System Make Sense?

A dramatic twist emerged in the summer of 2007, when the AMPTP, represented at a press conference by the heads of three networks (Warner Bros., CBS, and ABC) publicly called for a complete overhaul of the almost 50-year-old system of residuals for writers, actors, and directors. The Web was clearly at the heart of the debate, with the studio and networks initially rebuffing any attempt to extend residual-type payments to Web, download, streaming, and other digital media exploitations.\textsuperscript{102}

What started as debate about extending residuals to online/new media revenue streams, was seized on as an opening to turn the whole system, perceived to be out of whack, on its head. Warner Bros.’ Barry Meyer, serving as spokesman for the AMPTP group, was quoted in Broadcast & Cable lamenting that fixed payments were being made when projects were still in the red and arguing that production costs need to be recouped before paying out residuals:

“The goal,” Meyer said, “is to find a way to recoup the sizeable investment in movie and television programming before there is a sharing of profits with anybody. Why . . . does the model work that says you have to reuse that product trying to recapture a loss? Why isn’t there a model that says once the investment is recovered, maybe there should be a higher percentage paid of the profits? . . . It is clear to us that those old models don’t work anymore, that models based on reuse of programming before you’ve recouped your costs, or any semblance of costs have been recouped, don’t work anymore. And we think that the study we’re asking for has to look at that.”\textsuperscript{103}
Countering the AMPTP view, the guilds, deeply suspicious of “Hollywood accounting” (see Chapter 10) outright rejected the notion that a profits-based system could be fair. SAG’s president bluntly noted that they did not need a study to show that a sharing mechanism based on profit accounting “would be inaccurate, unreliable and unfair. Talent can’t be asked to share the profit risk when creative artists have no control over what projects are made or how they are budgeted—particularly for promotion and advertising.”

In the end, probably recognizing that scrapping residuals was too severe a change, the studios backed down a bit and the parties agreed to formulas in both streaming and EST contexts.

After the DGA and WGA settled their differences over the treatment on “new media” residuals and, respectively, agreed to new collective bargaining agreements (2007), SAG elected not to follow suit and was stalled in protracted negotiations with the AMPTP. Oddly, despite the difficulty in reaching an overall accord, both sides were in apparent agreement regarding a residual formula for the principal new media categories: (1) when a consumer pays to view a TV show or movie via a new media platform, including in the instance of downloads-to-own (EST); and (2) when a producer makes a TV show available via advertising-supported streaming. SAG’s website, under a special bulletin pertaining to the negotiations, advised that if a TV show “were to be streamed on the Internet, it would have 24 free streaming days... Then, after the 24 days of streaming, they would have the right to exhibit the episode for two 26-week periods if they pay 3 percent of the applicable minimum for each 26-week period. In the case of a day performer who works one day, that comes to approximately $22 for each 26-week period...” The calculations can become complex, as in the instance of EST the SAG website additionally noted: “the casts would share in 5.4 percent of 20 percent of the DGR (distributor’s gross receipts) up to the first 50,000 units downloaded for features and up to the first 100,000 units downloaded for
television programs.”

I need not elaborate on the arcane workings of the Hollywood collective bargaining agreements (which are about as easy to follow as the arcane accounting of net profits, which is discussed in Chapter 10 and similarly divvies up shares of shares of receipts), which over time will continue to haggle over splitting the online and download pie; the point is as first noted, in that even while immature, revenues associated with digital/streaming of content are a lightning rod, and guilds are adamant about participating in what they correctly perceive as a growing pie.
CHAPTER EIGHT: Ancillary Revenues: Merchandising, Video Games, Hotels, Pay-Per-View and Transactional VOD Roots, Airlines, and Other Markets

[The following excerpts are reproduced from the 2nd Edition without modification]

Chicken and Egg: When Merchandising Drives TV

...According to 4Kids Entertainment’s annual report, “The Company, through a multi-year agreement with Fox, leases Fox’s four-hour Saturday morning children’s programming block. The agreement, which commenced in September 2002, requires the Company to pay annual fees of $25,312 through 2006.” The annual report continued:

The Company, through a multi-year agreement with Fox, leases Fox’s Saturday morning programming block from 8 a.m. to 12 p.m. eastern/pacific time (7 a.m. to 11 a.m. central time). In January 2005, the Company changed the name of the Saturday morning programming block from Fox Box to 4Kids TV. The Company provides substantially all programming content to be broadcast on 4Kids TV. 4Kids Ad Sales, Inc., a wholly-owned subsidiary of the Company, retains all of the revenue from its sale of network advertising time for the four-hour time period.

Fox secured over $100 million over four years without any risk, presumably on the assessment that it could not sell $25 million of advertising per year in this space or otherwise net better than this amount after programming costs. The network’s bet seemed to pay off based on the 4Kids report, which lists advertising media and broadcast revenues for 2002, 2003, and 2005,
respectively, as $11.2 million, $22.54 million, and $24.1 million. In addition to running a deficit on the airtime, 4Kids had programming costs to amortize. And yet, as the report further noted, the company’s belief that TV exposure would drive other revenues tied to the already established franchise justified the risk: “The ability of the Company to further develop its merchandising, home video, and music publishing revenue streams were significant components of its evaluation process which resulted in the decision to lease the 4Kids TV Saturday morning programming block.”

In the context of leveraging well-known brands with strong merchandising lines, the 4Kids Entertainment strategy of broadcasting new (and inexpensive-to-produce) series on network to drive awareness for ancillary revenue streams was a bold play. However, absent this context the notion of paying for production, receiving no license fee (and, in fact, having a negative license fee given the lower ad revenues versus the cost of the airtime), and betting the entire economics on ancillary revenues may carry worse odds than gambling.

Most Extreme Example: Toys Programming a Whole Network

The natural extension of a producer or toy company programming a block of TV content is to take over and program an entire channel. With exposure difficult and a few key players controlling the network flow, both independents and toy companies have sought ways to become both the programmer and owner.

In 2009, Hasbro bought 50 percent of Discovery Kids to launch The Hub, a new children’s network with a reach of approximately 60 million subscribers. While Discovery managed advertising sales, programming was the responsibility of Hasbro—meaning that a toy company
was able to leverage a major cable network to promote its brands (e.g. *Transformers*), with animated series such as *Transformers Rescue Bots* and *Transformers Prime*. In the end, conflict between the parties, including alleged friction over Hasbro valuing toy sales over ratings, led to Discovery taking a majority stake and rebranding the cable network as Discovery Family; as a minority partner, Hasbro continues to program a block of daytime kids fare. At the time of the shift, Animation World Network reported: “Hasbro apparently regarded the partnership with Discovery as a way to drive toy sales, and that often led the toy maker to balk at supporting shows that had good ratings but weren't moving product.”

Another example of a children’s production company launching a network is PBS Kids Sprout. The channel originally launched in 2005 as a partnership among Comcast, HIT Entertainment, PBS, and Sesame Workshop. HIT Entertainment, launched originally as the overseas television arm of the Jim Henson Company (Henson International Television), had gone public and bought the iconic U.K. brand *Thomas the Tank Engine*. The new network enabled HIT to have a direct television outlet via which to air series and cross-promote its brands. Over time different entities vied for the promotional platform, which is now under the umbrella of Universal Kids. First, in 2011, Mattel bought HIT Entertainment, bringing not only *Thomas the Tank Engine*, but global brands *Barney* and *Bob the Builder* under its umbrella; however, HIT’s ownership interest in Sprout was not part of the transaction (note: that split made sense given the educational focus and mission of PBS and Sesame Workshop, which would arguably have been in direct conflict with having one of the two largest toy companies (Mattel) as a major owner). However, in the last few years Comcast (the parent to NBCUniversal) ended up consolidating ownership and also acquiring DreamWorks Animation; the media group via Universal Kids now looks to leverage that broader content to compete head on with traditional
kids TV heavyweights Disney Channel, Nickelodeon and Cartoon Network.

**Hotel and Motel Market**

*The following is reproduced from the 2nd Edition without modification*

**Size of Market and Window**

This is a market (US) of a few million hotel rooms that are serviced by various providers, although given the relatively small scale a few providers have historically dominated the market (e.g., LodgeNet, which a few years ago purchased rival On-Command).

As with other distribution windows, the hotel/motel window is jockeying for its exclusive bite of the entertainment pie. Traditionally, this window has been slotted between the theatrical release and the video release. Regarding theatrical, the concern is to capitalize on the exposure in theaters and the awareness generated by the theatrical marketing campaign, while not taking any business away from the theaters. Accordingly, the window generally started in the range of 8–12 weeks from the theatrical release. Very few movies today remain in theaters for this long, however, and to the extent the films are playing out that far, the locations and screen counts have diminished to a marginal number. The issue, then, is: What is “marginal,” and would the availability of the film in a hotel detract from potential box office? Most theatrical executives would argue no, and the window from theatrical has been growing shorter over time.

A key factor influencing the timing is also seasonality, as hotels have peaks around holiday times, especially in the summer. Accordingly, July and especially August tend to be peak months. While the rhythm of the market used to be monthly, even the hotel/motel market is
impacted by changing technology and the switch to digital media. With the ability to deliver and
program digitally (versus physical tapes), hotels can now switch out programs with ease. This
means that hotels are able to rotate in new programming more frequently, and in the last few
years it has become possible for movies to have variable start dates (as opposed to the historical
pattern of first of the month rotation tied to physical elements). Additionally, as availability dates
can now be programmed flexibly, it is fair to hypothesize that a form of pay-per-view (PPV) will
fully cannibalize the hotel window, and this revenue cycle will be absorbed and consolidated into
a VOD/pay-per-view revenue pattern.

Finally, the length of the window is variable, but in some cases can run several months.
Intuitively, this is longer than one would expect, because it cuts into the video window. To
permit a longer window, it is therefore fair to posit that the distributor: (1) will assume the
impact on video will be nominal (reasonable if viewed as an impulse buy, and non-substitutional
if assuming you would not rent a video out of town, though a weakened argument as all access
moves to VOD-based); and/or (2) has a compelling economic justification, such as receiving an
advance guarantee (which, if high enough, needs time to be earned out). It will be interesting to
watch whether this flexibility remains as video windows transition to on-demand viewing, and
whether hotel/motel remains separate or becomes consolidated into VOD generally; because
there is little incentive to upgrade systems and hotels earn margin on higher pricing from captive
audiences (see below), any transition may apt to be slower than the pace of what technology
enables.

_Economics_
Hotel/motel revenues are obviously dependent on guests paying to view a movie, and the frequency of ordering a program in the hotel is labeled the “buy rate.”

In terms of pricing for buys, the average consumer price is at a slight premium to a theatrical ticket price and can be even higher for a hot new title (e.g., $11.95). Pricing in this window, unlike theatrical pricing, has a fair measure of elasticity; the cost may be less for an average title or discounted when a title plays later in the availability cycle. In summary, the overall pricing range is on the high side both because the audience is relatively captive (stuck in a hotel room) and because the availability generally is early; namely, in advance of any other in-home/in-room availability such as on DVD. The resulting revenues are then split between the distributor and the service provider in a negotiated formula (e.g., sliding scale), which no doubt takes into account anticipated buy rates, the speculative nature of buys, and the limited peak window.

The total amount of money generated in this window is small when compared to the major revenue streams of theatrical, video, and television; hence, this is a classic “ancillary” revenue source. The order of magnitude for gross revenues (buy rate multiplied by amount charged) on a major title should, in theory, be capped in the few million dollars range, given the relatively limited points of access.

Let us assume that one room is available for 90 days (e.g., six months, with an occupancy or turnover frequency of every other day), which means five buys equates to 5.5 percent. Compared to redemption rates, which tend, as a general rule, to be in the low single digits for most coupon-type offers, this buy rate appears high, and this in turn supports the argument of a capped range on the revenue stream. Continuing a simple example, a five percent buy rate against 2 million rooms with an average price per transaction of $10 would yield $1 million of gross revenues (100,000 transactions × $10). And remember, this is gross revenue; net revenue to the distributor
will be based on a split, which may be low if a guarantee is applied. If, for example, a film has grossed $3 million (triple the previous example) and the weighted average take from the distributor was 40 percent, then the net revenues would be $1.2 million. This is a fair example in terms of how the revenue stream should be viewed: if a successful film can earn a million dollars or more, and a lesser title a few hundred thousand, that is enough revenue to be worth the effort, yet not enough to be a driver of windows or a major source. Hence, we circle back again to the classic ancillary stream.

*International*

The international market is not as mature as the U.S. market. The issue here really is scale, for with the U.S. market being marginal in scale versus other revenue streams, the issue of resources versus return becomes a material concern internationally. The international market is fragmented, and turning a profit within a particular territory with a smaller population (and modern hotel infrastructure generally less sophisticated than the U.S.) becomes a challenge. While the international theatrical, television, and video markets have become major revenue streams, and in some cases surpassed the U.S. market, the same cannot be said of hotel/motel windows. In fact, this revenue stream/window is insignificant (and often nonexistent) for most theatrical fare. As for the future, I would argue that rather than seeing a maturation, it is likely that PPV and VOD opportunities are more likely to flourish and supplant what would have otherwise been a hotel window.
Transactional VOD and PPV

[The following is reproduced from the 2nd edition without modification]

PPV and VOD Roots

While PPV has been around for years, until recently being enabled by digital cable set-top boxes, it never matured beyond a relatively small ancillary market. Whether this was due to clunky technology, limited offerings, or simply a market that was not ready for the model, it was clear that the new pay-for-sampling-or-viewing world is changing the historical pattern of consumption.

In the early phases of growth, the limited ability of servers to hold and download programming (both the number of programs and the speed of delivery) created hybrids that were clearly intermediate technologies. What grew up were variations of PPV such as near video-on-demand (NVOD), which were euphemisms for technical delivery. Historically, PPV was an event platform, perhaps most notably associated with sports such as boxing (and fights and out-of-market sports league packages are still a driver of classic PPV). If you want to watch the fight, pay $X and you will have access—no other way to see it. It then evolved into also showing movies that cycled: every time the movie started again you could tap in and watch/buy it. The more servers, the more times a movie could cycle through, which allowed the chance to opt in more frequently.

This gradation of when a viewer could access programming, which was inherently a technical limitation, defined the window or right. If a viewer could gain access only periodically (e.g., live-event basis), then it was PPV. If a viewer could gain access frequently (e.g., every five
minutes), but not immediately, then it was defined as NVOD (imagine a back room of 100 VCRs all playing a tape of the same film so that the movie could start anew every few minutes). Anything accessed with nominal waiting time came to be classified as VOD, which clearly, over time, would come to simply mean instant access.

*Residential VOD: The Virtual Video Store*

Residential VOD had long been hyped as the ultimate consumer service: the technology promised the potential of a virtual video store environment unburdened by inventory costs, stocked with a catalog of limitless titles that were always on the shelf (wide and long tail), and accessible with the click of your remote. This ease of access to non-scheduled programming was a clear threat to the traditional broadcast television landscape, and added another challenge to a model that was already struggling to address consumers skipping the advertising that funded their production—as discussed in Chapter 5, not only is VOD a threat to TV, but residential VOD is in the process of fully cannibalizing the video rental market.

*Domestic*

In broad concept, there is little material difference between PPV and VOD (here, only talking about à la carte transactional VOD, and not subscription-based). In both cases, a consumer is able to pay to watch a program through his or her television at home. A flat fee is charged, and the program is available for viewing for a limited time. Historically, the movie, once ordered, would run like a live TV broadcast; however, with the advent of TiVo, and similar digital virtual
VCR devices, the programming can be accessed and played over an allotted period such as 24 hours from purchase.

As previously described, the principal difference between PPV and true VOD is that PPV services have specific start times. In contrast, VOD allows the customer to select a film and start it whenever they want. These video store via television remote control services enable the ultimate couch potato: not only are you watching on the sofa, but you have not even risen to visit the video store.

Historically, back-end technology limited the selection of content accessible, making the range of movies available via PPV/VOD a fraction of the inventory a customer could find at his or her local video rental store. With technology improvements, such limitations have essentially disappeared, and today PPV and VOD services fulfill the digital consumption mantra of consumers being able to access what they want, when they want. With VOD having subsumed PPV, the only remaining delineating factor is the window. The window limits access overall, defined by when content is made available to the VOD service.

Providers

Like the hotel market, this similarly limited revenue stream has been dominated in the United States by a few players (e.g., InDemand, owned by a consortium of the leading cable providers, including Time Warner, Cox, and Comcast). (Note: The direct-to-home-satellite market, which is dominated by Direct TV, largely parallels the cable VOD market, and accordingly macro-numbers should capture both platforms.) Around 2005–2006, this market started to take off, as digital cable boxes enabled simple access to content. Gross revenues continue to increase,
justifying aggressive marketing via cable systems such as Comcast’s branding of its Xfinity service. The new level of marketing was a clear signal that the market, which had been relatively flat for years, was entering a phase of potentially explosive growth—by 2009, InDemand reported it delivered 200 million paid transactions, and by 2012 it had increased its content offering to what it described as 70,000 hours yearly.\textsuperscript{112}

Window

The window for residential PPV/VOD has historically been post video release, in part because in-home viewing of a film in a manner characterized as via a virtual video store is threatening to video sales. Because the PPV/VOD providers want to capitalize on awareness, which has waned significantly since the theatrical release and then received a jolt of life from the video marketing campaign, they naturally want the window to be as early as possible. If they had their druthers, the window would replace the hotel/motel window. Protecting the more lucrative video window has been the key priority, so the next best time is as close to the video release date as possible.

The window used to be several months after video, but as video has matured from a rental to sell-through business, and as the preponderance of DVD sales have become front-loaded, the residential PPV/VOD window kept accelerating. Originally slotted a distant six months, improved cable system offerings pushed the window to three months and then only one month post video. By 2012, studios viewing transactional pay VOD as providing higher margins than the other predominant rental options (e.g., Netflix, Redbox; see the discussion of Redbox pricing in Chapter 5) took the final step, and Warner Home Video offered its new release titles via transactional VOD day-and-date with physical discs;\textsuperscript{113} moreover, cable VOD now markets its
offerings as being in advance of rental services such as Netflix and Redbox. There were
experiments with day-and-date VOD/DVD several years ago—when Disney tested the concept
via its MovieBeam service (before it divested the company), and fully collapsed the window and
also experimented with different pricing for new versus library films (see also Chapter 1)—but it
was not until the recent maturation of VOD, in combination with seismic shifts in the DVD
market, that the economics justified a permanent and broad movement of the window. (Note: A
premium VOD window has been set before DVD and closer to theatrical release, stirring
boycotts from theaters that are wary of any further encroachment on their window, as discussed
in Chapter 1.)

Again, lurking behind this window is a fear factor that VOD will fully cannibalize DVD
sales. This fear seems to be going away, with studios working harder to harmonize these streams
(leveraging one off the other) than they are to fight off cannibalization. (Note: Although there is
an incentive to preserve higher-margin DVD sales versus generally lower-margin VOD rentals
(see Chapter 5), so long as physical disc sales are material, this tension and balancing is likely to
continue.) To some degree, what synergies are best realized may turn on which division the
rights are coupled with: some studios place VOD under the video group, while others bundle
these rights with the TV group, and more specifically pay TV. The pay TV grouping occurs
because on the flip side of the window is pay television, coming several months following VOD.
As the pay TV window tries to similarly accelerate to come closer to the video window, VOD
has to fight to keep its positioning: close enough to video to capitalize on the marketing spend
and corresponding awareness, and short enough with enough space to allow the larger pay TV
provider to appear as fresh and early as possible. Because the consumer is only vaguely aware of
all this timing, the segmentation works and the revenues are maximized. This is another
illustration of the interplay of Ulin’s Rule factors.

Finally, coming back to the traditional/historical window, it is worth noting that because of this squeezed timing, the advertising of PPV/VOD availability to customers is in close proximity to the actual availability date. While improved marketing efforts (such as by the key cable operators) and the maturing market are changing awareness levels, historically relatively few people are aware that a title will be coming to VOD, as opposed to awareness of video availability. This historical lack of marketing (which is changing the more that VOD becomes the face of video rental), combined with VOD lending itself to a browsing pattern, means that VOD purchases tend to be impulse buys.

I have not seen specific market research on this issue, but I would speculate that most consumers traditionally ranked VOD as a default choice, scanning VOD availability when they were dissatisfied with the other choices on TV. Perhaps the VOD/PPV operators should be paying Bruce Springsteen for his lyrics “57 channels and nothing’s on,” for it is the dissatisfied channel surfer already tuned to his or her TV who is most likely to divert to the VOD tangent and be swayed to plunk down a few dollars for instant gratification (if not literal salvation from the negative experience of not finding something on TV that excites him or her). As the market matures, and as VOD becomes more of the norm, then it is fair to expect the consumer pattern to shift and VOD to become the first menu scanned—a change that is already happening, with “what’s new” hosted programming appearing as users move to browse VOD offers (produced by MSOs such as Comcast) already supplanting the static “upcoming titles” signs at video rental stores. Arguably, this will be the tipping point for window changes, but as described in Chapter 7, the competition from OTT services requires sea changes in strategy, not minor window tinkering.
As the consumption pattern shift was accelerating, I asked Jamie McCabe, Fox’s executive vice president, worldwide VOD, PPV, EST, how he saw the market’s maturation, and he advised:

The fastest-growing segment of VOD is that of the OTT services of all business model: SVOD, free on-demand, and transactional rental and sale. Once dismissed as an inferior video pipeline that would be reserved for short-form content, now Internet video services have grown exponentially as consumers continue to connect not only their big screens, but increasingly engage in smaller-screen personalized viewing.

The breadth of content offerings, sophisticated search engines, visually compelling merchandising, and the seamless integration with multiple devices have fostered a trend toward OTT long-form video growth. The efficiencies, scale, and global device relationships have allowed these services to broaden their availability outside the U.S., in some cases ahead of entrenched video incumbents. MVPD providers are responding to this trend by introducing their own multi-screen offerings, extending their reach well beyond the set-top box.

In my prior edition, when VOD was on the rise but the over-the-top market was still in its infancy, Jamie had presciently noted about the inherent pull of VOD generally: “Once given the benefits of choice, control, and instantaneity, users are very satisfied and the VOD habit is formed.” Today, I would argue VOD is the new habit and the landscape change is no longer about the rise of VOD, but rather the access points, as over-the-top and Internet-enabled devices have changed the matrix from “get everything you want now” to also “get it at home or on the
go” (see Chapter 7). I recognize that I have digressed a bit from the promise of only describing VOD roots, but given the degree of convergence, it would be misrepresentative to only describe PPV as if VOD and OTT access were in no measure related.

Economics

The PPV and VOD markets tend to work on straight buys, which makes sense given the general impulse purchase. This construct then lends itself to a revenue sharing, or sliding scale model (akin to hotel/motel), with the content provider in position for a larger share absent minimum guarantees. Without an advance, the VOD service can be viewed as simply a pipe or a location for access, such as a movie theater, with a form of sharing matching relative risks taken and the unpredictability of direct consumer consumption.

In terms of macro values/revenues, this window used to be a truly ancillary stream when compared with video, TV, and theatrical revenues. In my first edition, though, I posited that the revenues would become more valuable than hotel/motel and, as an order of magnitude, a strong title properly positioned should theoretically be able to earn a multiple of the money earned from hotels. This bump versus hotel makes sense, for the universe of customers is larger, and the larger base directly corresponds to greater consumption. The tempering factor to the relative market size (base) is timing, as the further out exposure is from the video marketing campaign, the less “fresh” a title seems and the buy rates tend to diminish. In 2012, though, the evidence was finally in, and the promised upside from VOD rentals was demonstrated by the film *Bridesmaids*. *Bridesmaids* was rented 4.8 million times, and grossed more than $24 million through VOD services, making it in 2012 the then top VOD title ever; moreover, if traditional
VOD (e.g., Comcast-type cable VOD services) is combined with Internet VOD (iVOD, such as available via Amazon on Demand), hotel and motel, and electronic sell-through, the title generated more than $40 million. The same title crossed the $100 million threshold in DVD sales, but what was most interesting is that when looking at traditional VOD and iVOD rental transactions, the gross revenue was in the order of magnitude of 25 percent-plus of DVD revenues—it is not difficult to see that as DVD revenues continue to decline (or, at best, flatten) and VOD and iVOD continues to grow, that this market will mature from a smaller ancillary market to a major life-cycle market. In fact, as discussed, VOD is already the new rental, and it is only a matter of time before it surpasses traditional video revenues.

While it is relatively easy to posit that VOD will continue to gain in influence, a trickier question is: What form of transactional VOD will be the most common? Namely, will the cable and satellites services, such as Comcast’s Xfinity, become the next Blockbuster, or will OTT services and digital technologies come to dominate? Traditional VOD services have had a head start, and are not surprisingly in the lead: by the end of 2011, the market for paid movie rentals by pay/transactional VOD services was $1.3 billion while the iVOD market was a fraction of the size, at $204 million. Although the growth rate of iVOD continues to be robust, cable’s stronghold in homes has so far allowed it to stay dominant. (Note: Netflix type SVOD is excluded here, as just focusing on transactional VOD.) In 2012, the NPD Group reported: “Led by Comcast in the first half of 2012, 48 percent of all paid video-on-demand (VOD) movie rentals were generated from cable VOD. With a 24 percent rental-order growth rate year-over-year, telco VOD is the fastest growing segment of the VOD market, outpacing the IVOD growth rate of 15 percent.”

Despite OTT VOD being the smaller piece of the transactional VOD pie, it is clearly growing
quickly, and is viewed by many studio executives as the fastest-growing new segment. When (and, in fact, whether) it will surpass cable/satellite paid VOD is an interesting question, and but for the installed base of cable, coupled with deep marketing pockets, I would say iVOD leading the market is a good bet—part of a sorting out of the new equilibrium will depend on price, and part demographics, but the cable companies need to be wary of the generational shift where viewers do not need to “cord-cut” because they have had easy access for years with no cord at all (so-called “cord nevers”).

Finally, as forms of VOD come to supplant video rental, then it also makes sense to see a harmonizing of the VOD charge and video rental fee—a convergence that is already happening. Also, not surprisingly, VOD pricing is less expensive than renting a movie in the hotel/motel window, arguably because: (1) it is not a captive environment like a hotel room; and (2) the PPV/VOD window is significantly later in the life cycle than the hotel/motel window. The resulting charge to the consumer for viewing the same film at home via VOD/iVOD may be less than half of what it would have cost to see the same film a few months earlier in a hotel room.

International

Unlike the hotel market, with the larger residential VOD consumer base available to be tapped, the international VOD market is growing faster and is generally exploited on most major studio product.

Similar to the United States, the maturation of this window had been held back both by waiting for available technology to execute efficiently and the overriding paranoia of negatively impacting the immensely valuable (and, until recently, stable) video market. Also, paralleling
U.S. trends, with the maturation of the sell-through video market, VOD availability has been perceived as less of a threat. As a result, the standard window for VOD in most major international markets has also been creeping forward toward the video availability date, and like the U.S. is apt to become simultaneous with video and become the face of rental.

One interesting difference that may differentiate economics is that while non-Internet VOD in the United States has been dominated by cable, in many global markets where satellite delivery (rather than cable) is the norm, the set-top boxes tend to be part of/distributed by the pay TV services. Accordingly, content suppliers diversifying their deals with pay TV channels to also license VOD rights will naturally look to pay TV structures. Pay TV licenses, however, are premised on minimum guarantees (tied to subscriber bases), whereas VOD deals tend to be structured as revenue shares because of the uncertain buy rates from customers. One can expect that as these markets mature, business models will shift with them; if deals start with guarantees to acquire content (mimicking pay TV structures), then over time they will adjust to reflect the value of buy rates, or change to a revenue-share basis dovetailing with the à la carte nature of impulse buys.

Complicating the picture is the fact that in some territories, broadband and phone company providers are aggressively entering the market; leveraging online delivery/access systems, these companies are trying to co-opt the VOD market by converting their subscriber base and directly competing with the pay services. Accordingly, in some markets, phone company affiliates are battling the pay services; in others, it is broadband services versus pay TV providers; and, in some markets, cable, broadband, phone, and pay services are all competing for VOD. The one common thread is that everyone seems to acknowledge that VOD, grounded in the new on-demand, more open-access-to-content psyche, is the next great frontier.
Airline Licensing Economics

[The following is reproduced from the 2nd Edition without modification]

Even today, license fees can still be structured in what seems a bit of an archaic manner: flat fees per film per flight. While general pricing has been relatively flat for years, differential pricing has evolved where there may be a charge for the main screen plus an incremental amount per flight for the on-demand systems. Fees overall can reach a reasonable number because licenses are usually nonexclusive; accordingly, while the price per film/flight may be relatively low, there is a significant multiplier effect (multiplied by number of flights, and then multiplied by number of airlines). Nevertheless, the ultimate revenues are not likely to approach the multimillion-dollar levels of other revenue streams.

For a studio that is regularly licensing a few films per month to an airline, the relatively small per-film revenues can add up over time. Airlines are thus another classic “ancillary,” for even though the revenue is small and incremental, it is still significant enough to maintain and exploit the niche. What is slowly changing, and will ultimately make the traditional pricing extinct, is broadly implementing in-seat VOD offerings. When you can select a film and pay by credit card, such as on Virgin America, then the model should naturally shift to a revenue-share scheme akin to models utilized historically in hotel/motel PPV. Even with this major shift in pricing and access, the inherent capacity barrier remains, and airlines will still only be a piece of the overall ancillary basket of revenues.

VIDEOGAMES

The recent growth of the videogame industry creates a sense that game tie-ins are some-
what new, and to be classified within the sweep of new media exploitation; however, the 
studios, in fact, have been trying to match game releases with films for well over 20 years.

Roughly 25 years ago, Universal tried to accelerate a game designed for the Atari 2600 
tied to *E.T. the Extra-terrestrial* when the Steven Spielberg film was generating unprecedented 
buzz on its way to becoming a classic. The rushed time frame was commonly cited as the 
reason for the game’s failure. Despite having only a matter of weeks to make the game, the 
*Los Angeles Times* chronicled that hopes for blockbuster sales ran so high that there were more 
games manufactured than Atari consoles. More than 1 million cartridges wound up being 
dumped in a New Mexico landfill, and the fiasco was blamed for helping spark the 1983 crash 
of the videogame industry.

This example highlights one of the most difficult and critical elements plaguing the 
industry and is as relevant today as 25 years ago: developing and timing a game release to tie 
in with the release of a movie is extremely challenging. The following simplifies yet strikes at 
the heart of the challenges of a film-based videogame:

- A game must still be good in and of itself, including game play
- A game can take more lead time than a movie to develop, produce, and publish
- A game is a different type of product which is fundamentally interactive versus a 
  movie which is inherently passive
- Not all properties lend themselves to good games

Each one of these points is critical, and failure to address any one can undermine a game’s 
success. What makes a game good is obviously subjective (games are another type of experience 
good), but to an extent this can be linked to the second point regarding the development period.

The development and greenlighting of a game is not entirely dissimilar to the development
process for any other type of story-driven piece of intellectual property. There needs to be a
strong production team (lead designer, lead artist, lead technical director, producer, writer); a
story that is appropriate to the medium (here, with appropriate levels of pay offs as opposed to
more formulaic plot points in a film or TV show); and core characters, etc. (Note: Not all games
are story-driven, so this analogy is limited.) To optimize results, time is needed, and a rush to
production in a game is as dangerous as any other medium, especially given the added complexity
of technical advances, the challenge of designing for multiple platforms (e.g., Playstation/X-
Box/Wii consoles, PCs, downloadable), and the need to hit platform cycles as new hardware is
introduced. (Note: In terms of marketing, the games industry often provides free demo versions.

These demos of limited game play or certain levels provide a teaser to address the
experience good quandary — not knowing if you like a product until you have consumed it —
and add a key element to the arsenal of inputs beyond reviews, trailers, and advertising.)

In many cases there will simply not be enough time to properly develop and produce a
game if the film is rushed and the game comes as an afterthought; namely, a movie that is
greenlit and targeted for production and release within a year or 18 months likely will not give
the game developer enough time to succeed, no matter how good the property may be.

Excluding game quality, many of the key factors for a film-based game performing well
are strength of a franchise, box office success of the film tied to the game, marketing, and
timing of game release to the film. Simply isolating box office and limiting the field to games
released simultaneously with films demonstrates a generally positive correlation, as depicted by
the following graph (Figure 1): [Note: Not Updated Since 1st Edition]
Sources: NDP Group, Boxofficemojo.com, and CEA Autumn Games; includes only games released within film release window.

As another data point, Table 1 charts a number of the top games related to films over the last few years: [Note: Not Updated Since 1st Edition]

### Table 1

<table>
<thead>
<tr>
<th>Game Title</th>
<th>US Game Revenue¹ (‘000s)</th>
<th>US Box Office² (‘000s)</th>
<th>Simultaneous Game and Film</th>
<th>Theatrical Release Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Spider-Man: The Movie 2</td>
<td>$143,748</td>
<td>$373,600</td>
<td>Y</td>
<td>6/04</td>
</tr>
<tr>
<td>Lord of the Rings: Towers</td>
<td>$102,880</td>
<td>$339,800</td>
<td>Y</td>
<td>12/02</td>
</tr>
<tr>
<td>Star Wars: Episode III</td>
<td>$101,021</td>
<td>$380,300</td>
<td>Y</td>
<td>5/05</td>
</tr>
<tr>
<td>Lord of the Rings: Return of the King</td>
<td>$94,237</td>
<td>$377,000</td>
<td>Y</td>
<td>12/03</td>
</tr>
<tr>
<td>Movie Title</td>
<td>Sales 1 (M)</td>
<td>Sales 2 (M)</td>
<td>Film Status</td>
<td>Year</td>
</tr>
<tr>
<td>-----------------------------</td>
<td>------------</td>
<td>------------</td>
<td>-------------</td>
<td>------</td>
</tr>
<tr>
<td>Finding Nemo</td>
<td>$82,562</td>
<td>$339,700</td>
<td>Y</td>
<td>5/03</td>
</tr>
<tr>
<td>The Incredibles</td>
<td>$80,716</td>
<td>$261,400</td>
<td>Y</td>
<td>11/04</td>
</tr>
<tr>
<td>Transformers: The Movie</td>
<td>$80,699</td>
<td>$319,200</td>
<td>Y</td>
<td>7/07</td>
</tr>
<tr>
<td>Harry Potter: Chamber of Secrets</td>
<td>$78,007</td>
<td>$262,000</td>
<td>Y</td>
<td>11/02</td>
</tr>
<tr>
<td>Spider-Man 3</td>
<td>$75,484</td>
<td>$336,500</td>
<td>Y</td>
<td>5/07</td>
</tr>
<tr>
<td>The Godfather</td>
<td>$57,177</td>
<td>$133,700</td>
<td>N</td>
<td>3/72</td>
</tr>
<tr>
<td>Madagascar</td>
<td>$53,370</td>
<td>$193,600</td>
<td>Y</td>
<td>5/05</td>
</tr>
<tr>
<td>SpongeBob Square Pants — The Movie</td>
<td>$50,325</td>
<td>$85,400</td>
<td>Y</td>
<td>11/04</td>
</tr>
<tr>
<td>Harry Potter: Goblet of Fire</td>
<td>$49,094</td>
<td>$290,000</td>
<td>Y</td>
<td>11/05</td>
</tr>
<tr>
<td>The Simpsons</td>
<td>$44,099</td>
<td>$183,000</td>
<td>N</td>
<td>7/07</td>
</tr>
</tbody>
</table>

Sources: ¹NDP Group, US Retail Games Sales. ²BoxOfficeMojo.com, reported US box office. ³CEA Autumn Games research.
CHAPTER NINE: Marketing

MPAA Average Distribution of U.S. Advertising Costs 2007

2nd Edition Figure 9.1 MPAA Theatrical Marketing Statistics: MPAA Member Company

Note: Other media includes cable/other TV.
### 2nd Edition Table 9.3 Marketing Cost Breakdowns for Selected Films

<table>
<thead>
<tr>
<th>Studio and Distributor</th>
<th>Domestic Box Office</th>
<th>Total Media Marketing Costs</th>
<th>Network TV</th>
<th>Cable TV</th>
<th>Newspaper</th>
<th>Radio</th>
<th>Magazines Spot TV</th>
<th>Internet</th>
</tr>
</thead>
<tbody>
<tr>
<td><em>Enchanted</em> (Disney)</td>
<td>$127.8</td>
<td>$44.6</td>
<td>$11.7</td>
<td>$11.6</td>
<td>$6.2</td>
<td>$0.1</td>
<td>$0.1</td>
<td>$13.0</td>
</tr>
<tr>
<td><em>Shrek the Third</em></td>
<td>$322.7</td>
<td>$45.1</td>
<td>$20.6</td>
<td>$11.6</td>
<td>$4.7</td>
<td>$0.1</td>
<td>$0.1</td>
<td>$5.2</td>
</tr>
<tr>
<td>(DreamWorks/Paramount)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><em>I am Legend</em> (Warner Bros.)</td>
<td>$256.3</td>
<td>$39.8</td>
<td>$21.7</td>
<td>$6.8</td>
<td>$4.4</td>
<td>$0.0</td>
<td>$0.0</td>
<td>$4.0</td>
</tr>
<tr>
<td><em>Spider-Man 3</em> (Sony)</td>
<td>$336.5</td>
<td>$41.7</td>
<td>$17.7</td>
<td>$9.5</td>
<td>$4.9</td>
<td>$0.6</td>
<td>$0.3</td>
<td>$5.1</td>
</tr>
<tr>
<td><em>The Bourne Ultimatum</em></td>
<td>$227.5</td>
<td>$36.9</td>
<td>$10.2</td>
<td>$10.0</td>
<td>$5.5</td>
<td>$0.5</td>
<td>$0.1</td>
<td>$2.8</td>
</tr>
<tr>
<td>(Universal)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><em>Live Free or Die Hard</em> (Fox)</td>
<td>$134.5</td>
<td>$33.6</td>
<td>$14.0</td>
<td>$9.0</td>
<td>$3.9</td>
<td>$0.5</td>
<td>$0.0</td>
<td>$4.0</td>
</tr>
<tr>
<td><em>Music &amp; Lyrics</em> (Warner Bros.)</td>
<td>$50.6</td>
<td>$35.7</td>
<td>$15.5</td>
<td>$6.5</td>
<td>$5.2</td>
<td>$0.0</td>
<td>$2.1</td>
<td>$5.3</td>
</tr>
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</table>

Note: all figures in $ millions.
Video Marketing

[The following section is reprinted from the 2nd Edition without modification]

Even though it is an ancillary market, in many ways video marketing more closely parallels theatrical marketing than television. Virtually every major category of costs comes into play in a video campaign for a major/tentpole film: trailers, posters/box art, commercials, press/PR (and, in rare instances, even promotional partners). Video marketing can be more complex because of the need for direct-to-consumer marketing (like theatrical) and the need to coordinate in-store, retail-specific campaigns (unlike theatrical) requiring significant trade marketing. While theaters may have posters, and an occasional standee, “in-theater” promotion tends not to be on the scale of campaigns run by major retailers such as Best Buy and Walmart.

2nd Edition Table 9.6 Video Marketing (%)

<table>
<thead>
<tr>
<th>Year</th>
<th>Network TV</th>
<th>Cable TV</th>
<th>Spot TV</th>
<th>Syndi TV</th>
<th>Newspaper TV</th>
<th>Magazine TV</th>
<th>Outdoor TV</th>
<th>Internet TV</th>
<th>Radio TV</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>43.4</td>
<td>25.1</td>
<td>6.5</td>
<td>4.7</td>
<td>1.4</td>
<td>16.2</td>
<td>0.6</td>
<td>0.0</td>
<td>2.2</td>
</tr>
<tr>
<td>2005</td>
<td>38.3</td>
<td>32.1</td>
<td>5.7</td>
<td>2.8</td>
<td>1.1</td>
<td>14.0</td>
<td>0.3</td>
<td>2.1</td>
<td>2.3</td>
</tr>
</tbody>
</table>

Macro-Level Spending/Media Plan and Allocation

The same type of media allocation graphs and charts as previously depicted in the theatrical context can be drawn for video. Paralleling theatrical campaigns, television spending is traditionally the dominant direct cost category. Near the peak of the DVD sales curve, this TV
percentage dwarfed all other categories, with the *Hollywood Reporter* noting: “There is one thing on which most studios agree: Allocating marketing dollars to the small screen makes sense. Nearly 80 percent of video marketing expenditures last year were for television commercials, with broadcast and cable in the lead . . .”

Table 9.6 lists allocations for the years 2003–2005 near the peak of the DVD sales curve.

In terms of percentage spend, as a rule of thumb marketing budgets will often be targeted in the range of approximately 10 percent of anticipated sales, and in cases can approach double that number. Of course, there ends up being an inverse relationship to sales, as big hits with higher-unit volumes drive down the ultimate percentage, paralleling the trend with theatrical. For example, Disney spent $34 million-plus in marketing *Finding Nemo*, including $20 million-plus just for TV spots. While this represented the biggest video marketing campaign for a title that year, the *Hollywood Reporter* noted it was still but “a small fraction (6.4 percent) of the $536.7 million that Adams Media Research estimates the studio grossed from *Nemo* video sales.” Similarly, Fox ended up spending only 6 percent of the $200 million video revenues ($12.9 million) on *X2*.

As expected, and as the market has become more cluttered and competitive, expenditures rose and the allocation of media became more diversified. Big titles still need to hit threshold reach and frequency targets, but a variety of titles can be pitched into specialty markets, or in a more targeted manner, increasing the ROI for shifting some weight to the Internet and specialty cable. In 2005, again toward the DVD curve’s peak, Fox reputedly spent 5 percent of its video marketing on the Internet, evidencing the new trend. Its SVP of marketing communications, Steve Feldstein, highlighted to the *Hollywood Reporter* that strategy had moved well beyond simply buying TV spots: “There are a lot of elements that go into making a release into an
event—from publicity and promotional activities to generating in-store excitement—and with the Internet, it’s all becoming much more direct consumer marketing.”

This trend continues, with media spending increasingly diversified, and “digital” spending now diversified itself among classic Web targeting, mobile advertising, and social media. Many continue to point to mobile as the next great frontier, but advertising remains challenging given the limited screen size; the challenge faced by Facebook and others to efficiently monetize mobile is no more than the flip side of the challenge faced by studios to more efficiently utilize apps and smartphones to spread their message.

Commercials and Box Artwork; Retail Execution—

Point-of-Purchase, Posters, Trailers

Again, like theatrical, significant effort and money is focused on branding the property and creating sales tools. Commercials are critical in a DVD/Blu-ray campaign, and will need to be created just for this market—“buy it today . . .” Although not as common as with a theatrical release (and again limited to bigger titles), a variety of spots may be cut, with different lengths and targeted to different demographics. Trailers and posters do not play as prevalent a role, and tend to be used more for trade and in-store marketing.

The most significant addition to the marketing arsenal is the box artwork, which almost always is a new design/image. Designing the artwork is tricky, because in one shot the image must be true to the property, remind people of why they liked the film (e.g., featuring a character), have a collectible appeal (the goal is to get people to buy it), and also appear fresh (time has passed, and people always want something new). Whereas movies come and go in
theaters, this artwork/box will sit on shelves for months or even years as the continuing face of the brand to consumers long after the heat of the release. (Note: This same concept applies to TV box sets as well.)

Additionally, today the “box artwork” also becomes the virtual box artwork used for EST and scrolling through VOD options (including rental VOD such as Netflix). The challenge becomes that much greater in communicating a message that is apt to live on in digital thumbnails for the infinite reach of the long tail.

Retail Execution—Point-of-Purchase, Posters, Trailers

Until the Internet’s long tail takes over, shelf space is still supreme, and gaining retail support is the lifeblood of any DVD/Blu-ray campaign. This involves specific placement of titles, special merchandising opportunities (e.g., unique displays and standees in the form of specially produced corrugate), in-store events and signage (e.g., posters), and commitment to keeping the title in prominent positions. It also means outside-of-store advertising support, including in circulars and, if the property justifies it, in TV spots. Circulars are more important than most people recognize. Not only do they have very significant reach, but they are obviously directly tied to generating in-store traffic, the ultimate point-of-purchase (POP).

Beyond driving people into the store, campaigns are focused on capturing the attention (impulse buys) of consumers in-store, regardless of what brought them there to shop. In-store programs involve coordinating multiple placement opportunities such as front-of-store POP displays and signage, special in-aisle corrugate, near checkout racks, end-cap placements (e.g., in new release section), and in-line facings. Moreover, as the sales cycle continues, there may be
advance planning for subsequent waves, such as special positioning at holiday times and movement to studio-sponsored call-out areas (e.g., the Y Collection, best sellers).

To help distinguish in-store programs, certain retailer exclusives may be offered. This often takes the form of premiums, such as stickers/buttons/posters, but may also involve unique product SKUs (e.g., special artwork on box, packed-in merchandise). All of these special features may incentivize a particular retailer to support a campaign. This support may be in the form of allocated placement in the retailer’s catalog and circulars (which today can be easily searched online), in hard dollar expenditures on TV advertising, or extra in-store efforts and/or commitments. Money already exists to execute some of these activities from the co-op advertising and MDF allowances traditionally included within an overall marketing budget; the trick is to effectively spend these sums and earn an appropriate ROI.

*Press, PR, and Third-Party Promotions*

There is a halo effect from the theatrical release, which obviously benefits video, but as the stakes have grown DVD/Blu-ray marketers have learned a second bite at the PR apple pays dividends. All the studios will hold retail-focused summits, building up their future releases, outlining marketing data, plans, and tie-ins, and even bringing in talent from big pictures to excite the buyers. Further helping generate buzz for the release, studios will sometimes even sponsor “launch parties,” inviting key cast members and obtaining press coverage.

As DVD releases have become events, with trade awards for best DVDs (and, like any awards, with multiple subcategories to spread the glory), there are major press opportunities beyond staged parties. To create interest, ideally there needs to be a bit of a new story, which
leads many studios to focus on bonus features and navigation. As discussed in Chapter 5, fancy menus, director’s commentary, deleted scenes, documentaries, bundled games or demos, and even sneak peeks are examples of value-added material (VAM) typically produced for DVDs/Blu-ray discs.

In terms of economics, it is fair to question the production costs for these elements, as it is a difficult call whether and how much of this material is essential to stimulating sales. Certainly, there is value for collectors and fans, which may be sufficient in cases to justify large expenses; moreover, as discussed elsewhere, it is these “extras” that, in an online/VOD world, may be the differentiating value creating a justification to own physical content as opposed to renting or downloading digital versions that usually exclude VAM. Taking collecting out of the equation, I would argue that among the significant factors for the value-added elements is garnering media and press. These hooks help secure attention and interviews, gaining millions of “free” impressions that are additive to the hard media costs in terms of gaining awareness through targeted reach and frequency goals. Finally, as discussed previously, a critical part of any DVD/Blu-ray campaign is retail buy-in, and if you want the major chains to support a title, including featuring it in their own advertising, then you had better be supporting the title yourself.

Third-Party Promotional Partners

The largest category of third-party media placement is retail spending to execute in-store and to advertise (e.g., circulars). In somewhat rare instances, a promotional partner may tie into a video release, similar to the theatrical context where McDonald’s may theme in-store giveaways, or a
cereal company will co-brand a popular item. Every studio video marketing head dreams of these opportunities, but also laments that they can count on their fingers the number of times they have been able to execute this type of partnership, which inherently also would come with a third-party marketing commitment for direct consumer advertising. The fact remains that despite the rise of the video market and millions of dollars spent on DVD releases, promotional partners tend to associate this as an “ancillary” and rarely bring the support that is associated with a theatrical release. Nevertheless, select hits, and especially franchise titles, are sometimes able to secure this type of support, such as tie-ins with Papa John’s Pizza for the video releases of *Ice Age* (2002) and *Indiana Jones and the Kingdom of the Crystal Skull* (2008).121

*Net Sum*

The same type of analysis could be outlined here as with the theatrical market:

Distributor Media Budget

+ **Aggregate Retailer Media Budget**

= Total Direct Media Budget

+ Imputed Media Value of PR

+ **Imputed Media Value from Retailer Circulars**

= Total Media Weight
Certain Costs Always Deducted (e.g., so-called “off-the-top” deductions)

Certain costs are almost always deducted as “off-the-top” expenses for all participants. Even in the context of “gross” or “gross revenues,” these terms are actually net of off-the-top expenses; the amount remaining after the off-the-tops are sometimes conceived of as “gross” in terms of the revenue line from which all participants then look to apply deductions or percentages of revenues. The following are standard categories of off-the-top expenses.

Trade Fees and Dues

The studios are members of trade associations that lobby on their behalf and also fight common issues such as piracy. The most well-known group, as referenced in several instances throughout this book, is the Motion Picture Association of America (MPAA). The MPAA maintains affiliated regional offices throughout the world, and plays a key role in lobbying foreign governments on laws impacting piracy and the protection of intellectual property (see Chapter 2). Another association is the Association of Motion Picture and Television Producers, Inc. (AMPTP). This organization, including all the major studios and independents, negotiates union agreements with the various Hollywood guilds. Associations such as the MPAA charge dues and assessments that cover legal and administrative costs, and the studios recoup this money by
charging these costs back to pictures as an off-the-top deduction.

Checking

Checking here means costs borne by the studios to send “auditors” out to theaters to ensure that box office receipts (given the historically cash nature of the business, but less an issue today) are accurately reported. Depending on clout, these costs are often capped; moreover, as digital payments are now more customary this category is waning in importance regarding verification. (Note: The cost of collecting money due is also typically an off-the-top.)

Duties, Tariffs, and Licenses: Conversion

These involve costs incurred to permit the exhibition of the picture in foreign territories and the associated costs to convert foreign currency to U.S. dollars, including related costs of converting and transmitting restricted funds (restricted funds are less applicable today given the global economy).

Residuals

These are the payments (see Chapters 2 and 7) required under union collective bargaining agreements (e.g., Screen Actors Guild, Writers Guild of America, Directors Guild of America) for use of the picture in media post its initial release medium (e.g., television following theatrical).
Taxes

This does not refer to income tax, but rather taxes of whatever nature that may be levied on the picture (e.g., relating to the exhibition).

[The following material has been reproduced from the 1st Edition (online Supplement 2nd Edition) without modification]

ADJUSTED GROSS AND ROLLING BREAKEVEN

Adjusted gross refers generically to an intermediate type of participation, which has elements worse than first dollar gross and better than net. This can mean that there has been a reduced negotiated distribution fee, including a zero fee; typically, however, adjusted gross means that (1) there is a modified distribution fee and (2) major distribution expenses, including print and advertising costs, are deducted.

Table 3: Adjusted Gross Example

<table>
<thead>
<tr>
<th></th>
<th>10% Distribution Fee</th>
<th>Zero Fee (0%)</th>
<th>Notes and Assumptions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Box office (in SM)</td>
<td>200</td>
<td>200</td>
<td></td>
</tr>
<tr>
<td>Film rentals</td>
<td>100</td>
<td>100</td>
<td>Assume rentals @ 50% of box office</td>
</tr>
<tr>
<td>Distribution fee</td>
<td>10</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>Print costs</td>
<td>5</td>
<td>5</td>
<td></td>
</tr>
<tr>
<td>Advertising costs</td>
<td>40</td>
<td>40</td>
<td>(high)</td>
</tr>
<tr>
<td>Advertising overhead</td>
<td>4</td>
<td>4</td>
<td>Ad overhead @ 10% of advertising budget</td>
</tr>
</tbody>
</table>
Breakeven Tricky to Capture

As a truism, in order to hit profits, the revenues need to outstrip the costs. As a corollary to this principle, in a breakeven scenario with a fee, the revenue must go up to cover both the costs and the fee (if costs increase 5, going up 5 on revenue is not enough); the additional revenue needs to be grossed up by the fee on the additional costs (e.g., if costs go up 5, revenues go up 5+ (fee \times cost)), which at a 10% fee would be 5.5. Another way to express this is the following formula: \((\text{increased costs}) + (\text{fee} \times \text{increased costs}) = \text{additional revenue needed for breakeven}\). (And yet another way to approximate the revenue gross up needed to also cover costs is to divide the costs by the reciprocal of the fee \([5/(1-.1)]\)).

ROLLING BREAKEVEN

Different types of breakevens can be defined instead as ~rolling. This means that after the breakeven point is reached, additional distribution costs and expenses incurred will be applied. Depending on the definition, a distribution fee will be added onto those expenses (i.e., the distribution costs are grossed up by the amount of the fee on the expenses). I do not know who invented this or why. Definitions and schemes have evolved, and while the mathematical logic holds true, the complexity for marginal dollars to people who are paid a lot of money anyway is baffling.
Table 4

<table>
<thead>
<tr>
<th></th>
<th>Breakeven at 10% Fee</th>
<th>Additional Video $</th>
<th>Breakeven at 10%</th>
<th>Rolling Breakeven at 10%</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Box office ($M)</td>
<td>200</td>
<td></td>
<td>200</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Film rentals</td>
<td>100</td>
<td></td>
<td>100</td>
<td></td>
<td>Assume rentals @ 50% of box office</td>
</tr>
<tr>
<td>Video &amp; TV net revenue</td>
<td>70</td>
<td>(+20)</td>
<td>90</td>
<td></td>
<td>Assume additional video revenue</td>
</tr>
<tr>
<td>Total revenue</td>
<td>170</td>
<td></td>
<td>190</td>
<td>190</td>
<td></td>
</tr>
<tr>
<td>Distribution fee</td>
<td>17</td>
<td>[17]</td>
<td>19 (+=+2)</td>
<td></td>
<td>Additional distribution costs in rolling breakeven</td>
</tr>
<tr>
<td>Print costs</td>
<td>5</td>
<td></td>
<td>5</td>
<td>5</td>
<td></td>
</tr>
<tr>
<td>Advertising costs</td>
<td>40</td>
<td>[40]</td>
<td>40</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Advertising costs on video</td>
<td>20</td>
<td>[20]</td>
<td>24 (+=+4)</td>
<td></td>
<td>Assume additional costs (may be high)</td>
</tr>
<tr>
<td>Advertising overhead</td>
<td>6</td>
<td>[6]</td>
<td>6.4 (+=+.4)</td>
<td></td>
<td>Ad overhead @ 10% of advertising budget</td>
</tr>
<tr>
<td>Interest</td>
<td>10</td>
<td></td>
<td>10</td>
<td>10</td>
<td>(set high here to zero out example)</td>
</tr>
<tr>
<td>Negative cost</td>
<td>60</td>
<td></td>
<td>60</td>
<td>60</td>
<td></td>
</tr>
<tr>
<td>Overhead production</td>
<td>9</td>
<td></td>
<td>9</td>
<td>9</td>
<td>Assume 15% override cost of production</td>
</tr>
<tr>
<td>Profit/loss</td>
<td>$3</td>
<td>23*</td>
<td>16.6**</td>
<td></td>
<td>16.6 = 23 – (additional cost of 2 + 4 + 0.4)</td>
</tr>
</tbody>
</table>

*No additional costs and fees deducted since breakeven hit.

**Additional costs included as break rolls.
NET PROFITS MODIFIED BY OVER-BUDGET PENALTIES

Sometimes contracts will include a penalty for going over budget, which is targeted to set back the payment of net profits. This will only arise in the context of director and producer deals, as those individuals are vested with production management and budget responsibility as opposed to writers, actors, or composers (i.e., the penalty only applies extra costs to the people who theoretically could have controlled those costs). The so-called penalty is an artificial means of multiplying costs at a specific budget threshold. For example, if a production were budgeted at $25M, then a penalty may add $2 into the costs for every dollar the budget exceeds $25M; if the final actual costs were $30M (20% over budget), then the producer’s net profit calculation would have a basis of $35M for negative costs ($2 for each of the $5 over budget). One can imagine multiple iterations of penalties, tied either to a multiplier (e.g., double the overage) or timing (different penalties at different overage points, such as kicking in only after costs exceed budgeted costs by more than 110%).

These penalties are obviously strongly resisted, infrequently applied in practice, and when applied will often have contingencies and exclusions. A typical exclusion would be if there were extra costs caused by an event of force majeure, as the producer/director should not be penalized by events out of their control leading to overages.

Circumventing Net Profits:

Artificial Breakeven and Bonuses in Lieu of Profit Participations

Because of the complexity of calculating net profit participations, as well as the skepticism of participants as to whether they are being or will ever be treated fairly, alternative means of calculating contingent compensation have evolved. In the realm of animation, for example,
various studios/production companies have created artist pools from which talent may share in profits. This is Hollywood’s version of profit sharing.

**Box Office Bonuses**

The most common and simplest method of circumventing traditional net profits is to pay box office bonuses. This means that when the box office of a film reaches a threshold, a fixed sum (bonus) is automatically paid. This can take the form of a set amount tied to a box office number, such as $1M paid as a bonus when the domestic box office hits $100M. Alternatively, the trigger may be indexed to (1) a percentage of domestic box office, such as 150% of domestic box office, to capture worldwide results, or (2) the negative cost, such as when the domestic box office reaches $2 \times$ negative costs.

These triggers have the benefit of simplicity: domestic box office numbers are published and straightforward, and neither party has to deal with exclusions, allocations, or other issues that arise in net profits definitions. Moreover, there is an assumption that at certain thresholds the amount of money earned should cover the cost of production and distribution, which is the essence of net profits. In theory, at $2 \times$ negative costs there ought to be enough money to hit and pay out profits; with this simple definition, talent has a greater comfort level that they will actually see a tangible upside. Because these pools and triggers are set independent of knowing the actual final costs involved, and further because they are designed to give the participant the benefit of the doubt, they may be bounded by floors and caps. The pools may therefore have a maximum allotment such that no more than $X$M is funded.

In a talent pool that is funded by box office bonuses the production company or studio still needs to allocate the pool. The allocation will be based on percentages (director X may receive Y% of the pool), but the funding itself will be based on bonuses triggered solely by
box

office. It is a bit of an irony that in an attempt to move away from net profits, talent accepts a percentage of net profits with profits defined by a relatively fixed pool with triggers as opposed to the more convoluted net profit formula. In the end, though, is one more arbitrary or accurate than the other?

This type of compensation system is not as widely accepted because while it may seem fairer, the thresholds set are speculative and may in the end not correlate at all to actual profits. It is entirely possible depending upon costs, etc., that a payout could occur prior to real profits.

Moreover, the notion of net profits is designed to share only in a certain pool, and to provide some buffer to the financing party, and any formula creating an automatic trigger could potentially be more costly to the funding party.

Appendix A at the end of this Online Supplement outlines how pools may be structured by presenting three hypothetical variations.

PRODUCER’S SHARE — WHO BEARS THE COSTS OF WHICH PARTICIPANTS?

In a financing deal between a studio-financier and a producer, the contract will stipulate who bears which participants. In the simplest and most customary formula, a producer who receives 50% of 100% of the net profits will bear all the other third-party participants out of its 50% share. Careful attention is therefore paid to grants, as they are cumulative and continue to cut into the ultimate producer’s net.

Sometime producers will have language such that their participation may be reduced, but then puts in floors that (1) ask the studio to share the burden of third-party participants after
a certain point (2) and/or puts a floor on the reduction such that the producer may not be reduced beyond this point.

**Soft Floors**

A soft floor is the point in time when the studio shares the burden of the third-party participations that have reduced the producer’s participation. If the producer has, for example, 50% of the net profits reducible to a soft floor of 15% of the net profits, then the producer will bear third-party participants out of its share until it hits 15% (point for point reduction). Once the soft floor is hit there will be a formula under which both the studio and producer will bear further profit participations. Often this will be on a pro rata basis, and may be implemented by taking further participations off the top (e.g., effectively reducing the next dollar of gross receipts and then applying remaining deductions to get to net) rather than applying a dollar-for-dollar deduction of the third-party’s participation against the producer’s share.

As an example, Table 5 presents a scenario which assumes that a producer bearing all the participants (gross and net) has 50% of the net profits, reducible to a soft floor of 20%, with the next 50% borne by the studio with all excess participations off the top (i.e., borne according to the relative participation percentages, such as 80/20).

**Table 5**

<table>
<thead>
<tr>
<th></th>
<th>$</th>
<th>Assumptions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross receipts</td>
<td>200</td>
<td></td>
</tr>
<tr>
<td>Dist. Fee</td>
<td>40</td>
<td>20%</td>
</tr>
<tr>
<td>Dist. expense</td>
<td>60</td>
<td></td>
</tr>
<tr>
<td>Net profit</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>Studio</td>
<td>50</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>------------------------</td>
<td>-------</td>
<td>----------------------------------------------</td>
</tr>
<tr>
<td><strong>Producer</strong></td>
<td>50</td>
<td></td>
</tr>
<tr>
<td><strong>Net participation</strong></td>
<td>12*</td>
<td>Total of 15% (deduct gross in formula)</td>
</tr>
<tr>
<td>Gross participation</td>
<td>20</td>
<td>Total of 10%</td>
</tr>
<tr>
<td>Soft floor</td>
<td>20</td>
<td>Soft floor at 20% of net profits</td>
</tr>
<tr>
<td>Producer share</td>
<td>18 (50-32, excluding soft floor)</td>
<td></td>
</tr>
<tr>
<td><strong>Excess gross remaining after hitting soft floor</strong></td>
<td>2</td>
<td></td>
</tr>
<tr>
<td>Studio bears 50% of excess gross</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Net balance (from which producer will bear 0.2%)</td>
<td>1</td>
<td>Bourne in 20/80 ratio</td>
</tr>
<tr>
<td>Producer share</td>
<td>19.8</td>
<td>Producer net (20-0.2)</td>
</tr>
</tbody>
</table>

*If in the definition of net profits gross participations are deducted in getting to net, as is often the case, then the equation changes as 100 – 20 =80; accordingly, 15% of 80 = 12. For simplicity, in the above example I have kept net profits at 100.*

Again, why would someone want to do this? I have literally seen it argued that this is intentional complex to keep lawyers and accountants engaged, as part of the mystery of net profit calculations creating an arcane science understood and mastered by few (I will even admit an element of uncertainty in these examples, not personally being an accountant). While I believe there is an element of old boy’s club obfuscation, the real answer lies more in simple economics.

What happens in negotiations is that people create corridors tied to relative values and risks. Floors are important, as a producer who is vested in a project and otherwise has to bear third parties will feel strongly it should not drop below a certain point of participation. At that emotional level, the parties agree to share third parties such that the pain and further costs are shared, creating a partnership spirit. It is all about how the parties who are financing and
making the film agree to share the costs of a third party (usually a star) they both felt was so essential to the project that they agreed to jointly sacrifice a portion of their own upside and together share in paying that third party. Because neither party really wants to sacrifice, the sharing only occurs after the point where both sides already receive the essence of their deal and the remaining amounts are fine-tuned, punctuated to the point of complexity almost to make the point of hey, I’m helping you out but the calculations and amount I’m helping you out by only go so far.

Hard Floors

A hard floor is simply a variation on the soft floor ensuring that the producer’s participation will never drop below X% (basically guaranteeing a minimum profit participation percent-age). Language would simply be added that— in no event shall such floor be reduced below 20%.

PLETHORA OF ACCOUNTING STANDARDS/AUDITS

Understanding that there are multiple ways to calculate profits is half the battle. Much confusion and criticism can be diffused by grasping three different methods for calculating profits: in accordance with GAAP, based on tax accounting, and in accordance with contractual contingent compensation schemes (i.e., profit sharing). (Note: The following discussion is based on general industry knowledge/practices — I am not an accountant and advise readers interested in this area to consult specialists or materials focused on the nuances of tax and related accounting policies and procedures.)
GAAP, Tax Accounting, and Profit Participation Accounting

Film companies are corporations just like any other company, and calculate corporate earnings under Generally Accepted Accounting Principles (GAAP). These standards will be used to report earnings to the SEC (if in the US) and investors/shareholders. Regarding GAAP, the American Institute of Certified Public Accountants (AICPA) will issue position papers on policies specific to the industry. Whether you believe the net result makes any more sense in terms of valuing the performance of a company than the calculation of net profits is again open for debate. What is certain is that there are relatively clear rules to apply.

The AICPA Statement of Position 00-2 details accounting rules for the film industry, and as with all accounting the methodology can dramatically impact reporting and accordingly the results that film companies report to shareholders and the SEC. Three key areas related to a specific film project are (1) the treatment of capitalizing film costs, (2) the amortization principles applied to deducting these capitalized costs, and (3) the sanctioned methods for recognizing income related to the film property. These are a few areas that can skew results if not properly understood.

Recognition of Income

The full value of a film license is often recognized in the first year that the license begins, thereby frontloading revenues from the asset. This is because the rules state that revenues are to be recognized when (1) the film is complete, (2) there is evidence of a license agreement/sale, (3) the license period has commenced, (4) the amount of money due is fixed/clear, and (5) the ability to collect the fees/revenues is reasonably assured. In other words, if Studio X licenses the TV rights for the film in country X for a license fee of $1M for a license term of 7 years, the $1M is recognized as soon as the licensee rights to telecast the film mature (i.e., hold-
backs have expired and the licensee has the right to start broadcasting the film).

*Capitalizing Film Costs*

Films and television programs are treated as long-term assets (long tail, before the phrase was fashionable), and as such the costs of creating the film are not deducted as an expense but rather capitalized. Accordingly, the cost of a film initially shows up on a company’s balance sheet as an asset. The corollary is that the costs are not immediately expensed on the income statement, which has the effect of increasing the company’s profits. The impact of this rule is exacerbated by the fact that certain non-obvious items, many of which can be challenging to calculate and forecast, are allowed to be included within the film costs that are capitalized (e.g., development costs, portion of overhead based on the ratio of total company production overhead to general overhead).

The upshot from the application of these rules is that, at least initially, a company’s books can look much better than actual performance. Cash has gone out the door to produce a film, but the cash is not treated as an immediate expense to net against revenues from the film creating a rosy profit on the income statement. At the same time, the company’s balance sheet grows by the value of the film, which capitalized costs when factoring in overhead, interest, and anticipated profit payouts can be significantly higher than the actual direct cash cost of making the film.

*Amortization of Capitalized Film Costs*

Film costs are amortized annually based on a formula that looks at the percentage of revenues generated by the film that year versus the total revenues that the film is predicted to generate over its life (except that for the purposes of the formula the life is assumed to be 10
years from release). If in year 1 the film brings in $25M and the film is expected to earn $125M over its life, then in year 1 20% of the capitalized costs should be deducted.

The difficult, and therefore questioned, part of the equation is the estimate of future income. This is obviously subjective, and at the reasonable discretion of management; hence, this is a figure that will be scrutinized by auditors, and some consensus must be reached with the company on the numbers and assumptions. Not only is this a challenge (given the myriad of downstream markets and deals), but some unknowns can exist for years: imagine a scenario where a company is reasonably waiting for downstream ancillary sales that may seem viable, yet ultimately do not materialize or fall short. The result is that the denominator has stayed mistakenly high, and by the time it is corrected and costs are written off, it is years down the road and taken as a lump write-off. The write-off is dismissed as an extraordinary item, with the explanation that there were unexpected drops or problems in this or that market (which all may be quite valid). In the meantime, while this is taking place downstream, the company obtained the up-front benefit of the initial assumptions that may have led to increased reported profits and assets.

Now, given the above, how bad can the calculation of net profits to participants be?

*Tax Accounting*

The fact that companies keep separate books for GAAP and tax accounting is no different for entertainment companies than any other business. I am no more a tax expert than accounting expert, and for a more exhaustive treatment of this subject readers should consult a CPA or other text; however, I will offer a couple of thoughts.

Whereas the previously stated rules in GAAP accounting allow for the potential overstatement of revenue relative to what may be a common sense notion of profits, the
mindset for tax accounting swings 180 degrees the other way. Companies for tax purposes want to capture the most costs possible to reduce income and resulting taxes. Some argue there are subtle incentives to underestimate future revenues, thereby increasing the rate at which film costs can be amortized and deducted. Tax laws have evolved to impose penalties for abusing the latitude on estimates; nevertheless, tax books can reflect different amounts, and with the goals and rules being different this creates yet another picture of profits.

_Profit Participation Accounting_

Given these different standards, and the nature of net profit definitions and accounting, is there any doubt why so much confusion abounds and net profits is now spoken of in pejorative terms?

_Audits and Online Differences_

Accounting, at some level, is only as good as its verification. Because net profits are rarely paid, few participants actually audit; however, when a producer has a sizeable stake, audits are customary and all the intricacies and charges as previously discussed are scrutinized. This is the underbelly that exposes where all the revenue and costs truly lie, and without a doubt working on an audit of a box office hit can be the best education one obtains in the business. What is interesting in the growing online space is that audit rights are not always granted, and when they are there are few instances of actual audits taking place because the revenue at stake does not yet justify the expense (audits are expensive). As discussed in Chapter 5 regarding video, the complexity of tracking detailed costs, especially in foreign currency and on a pan-international rolled-up basis, is part of the reason royalties are used rather than revenue-sharing models splitting the net. It will be interesting to see in the online space, when more revenue is at stake, whether companies will dissect revenue sharing (because the numbers are trackable), or
whether assumptions will be enabled (again, the trust factor) to retain a simple percent/royalty structure when participants realize the extra costs and challenges to verify numbers.

**Appendix A**

**BOX OFFICE BONUS PROFIT PARTICIPATION HYPOTHETICAL**

**Table 6**

<table>
<thead>
<tr>
<th></th>
<th><strong>Studio A</strong></th>
<th><strong>Studio B</strong></th>
<th><strong>Studio C</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Eligibility</td>
<td>Define who qualifies, such as full-time employees who worked on the film.</td>
<td>May extend eligibility to all company employees, rather than just those on the film.</td>
<td>May also include a tenure element, such as a minimum amount of time spent on the film or at the company.</td>
</tr>
<tr>
<td>When is the pool paid and set</td>
<td>Pool set one year after the film’s release and paid in X installments.</td>
<td>Pool set six months after the film’s release and paid Y quarters thereafter.</td>
<td>Pool determined and paid on first anniversary of the film’s re-lease.</td>
</tr>
<tr>
<td>When pool applies</td>
<td>Payable after domestic box office reaches X times cost of production. X could be, for example 1.5, 2, 2.5, etc.</td>
<td>Payable after domestic box office exceeds a fixed sum, such as $100M.</td>
<td>Payable after the earlier of when (a) when domestic box office equals 2x cost of production or (b) when domestic box office equals $YM.</td>
</tr>
<tr>
<td>Size of pool (all starting from $ after the artificial breakeven set of when the pool is paid and set)</td>
<td>Fixed percentage from when pool applies. For example, if pool applies at 2x neg cost, negative cost is $50M, there are $250M of receipts, and the percent-age is 10%, then pool is $15M (starts at $100M and then 10% of $150M).</td>
<td>Fixed amount of cash indexed to domestic box office thresholds. For example, $X at $100M DBO, $Y at $125M, etc. May eventually be a cap.</td>
<td>May be a hybrid, such as from a starting point (artificial breakeven) up to a threshold $X, then fixed incremental $ for every $Y of additional domestic box office.</td>
</tr>
<tr>
<td>Individual participation within the pool</td>
<td>Percentage of participant’s salary on the film relative to total salaries on the film.</td>
<td>May be indexed to salary level, or totally discretionary.</td>
<td>Hybrid of salary percentage plus discretionary adjustment.</td>
</tr>
</tbody>
</table>


3 Though Anhui Xinke said the reason for termination was the other side being uncooperative providing materials to Shanghai Stock exchange. Source: [http://www.sohu.com/a/123845589_534582]

4 Wanda terminated the contract and walked out. Source: [The wrap, China clampdown puts the brakes on Dalian Wanda’s deal for Dick Clark Productions, Feb 21, 2017, Erich Schwartzel and Wayne Ma]

5 Recon Holdings dropped its bid.[Variety, China’s Recon Abandons Millennium Takeover Deal, Aug 30, 2017, Patrick Frater]

6 Huahua failed to may payment and walked out of the deal. [LA Times, Paramount Pictures loses Huahua Media slate film financing deal, Nov 07, 2017, Meg James and Ryan Faughnder]


10 SEC S-1 Filing: The primary result of giving pro forma effect to the Distribution Agreement as of January 1, 2003 is that we recognize revenue net of (i) DreamWorks Studios’ 8.0% distribution fee and (ii) the distribution and marketing costs that DreamWorks Studios incurs for our films, July 21, 2004.


14 https://www.sohu.com/a/120494361_508310

15 Qualified Cost of Production refers to the production cost expended in Qingdao with bill as proof. Qualified production costs include rental of field sites and studios, Setting of the scenes; Leasing of equipment; Employment of mass actors and temporary theatrical personnel; Accommodation, transportation and costumes; Post production, etc. It does not include the remuneration of leading actors, directors and producers.


19 “Megaplex Mania,” USA Today, November 17, 2005


22 MPAA Theatrical Market Statistics, referencing HIS Screen Digest.

23 “Can This Man Save the Movies? (Again?),” Time, March 20, 2006.

24 Regarding Avatar, “Avatar is New King of the World,” Box Office Mojo, January 26, 2010, by Brandon Gray, noting that, at time of breaking Titanic’s all-time worldwide box office record, “Avatar’s 3D presentations have accounted for 72 percent or $1.35 billion of its total gross. Breaking that down, 3D’s domestic share is 80 percent, and its foreign share is 69 percent.”

25 http://3g.163.com/all/article/DFK2LQ840517DH9L.html

