



Position Paper DIGITAL ROLL OUT KEY ISSUES FOR THE EUROPEAN INDEPENDENT DISTRIBUTORS February 2009

Growing concerns that the cost of the digital roll out via third party business models will be beyond the reach of independent distributors have recently been highlighted during the Europa Distribution Annual Conference in Estoril (November 20-22 2008).

While it is generally felt the market will resolve the switch for mainstream and mid-level theatres in the coming months, there are currently no viable financial models for independent distributors and theatres.

Digital is, in this sense, not just a new technology, it could significantly impact the circulation of films and the diversity of existing exhibition and distribution structures, especially the smallest ones. Authorities should be aware to see that this change will have an impact on their town, their region, their country. It is possible that if independent distributors and cinemas suffer then certain European films will suffer, perhaps even disappear.

Therefore, Independent Distributors have decided to write a position paper summarizing their fears but also their hopes and presenting some of their proposals for a faire, managed and quick digital switch.

CURRENT & FUTURE PRACTICE

- **How does it currently work with 35mm prints?**
 - o The Distributor gets free access from the producer/Sales agent to the source materials of the movie in its original version (Dub negative). He then produces, with support of a Laboratory, the relevant number of 35mm prints, adding a dubbed version and/or subtitles if appropriate.
 - o The Distributor and the exhibitor agree on how and when the movie will be shown in the theater.
 - o The Distributor sends the print to the theater, once the run is over, the exhibitor sends the print to the next theater, following the orders of the distributor.
 - o The Exhibitor sends the figures of Box Office and admissions to the distributor and receives then the invoice.

- **How will it work?**
 - o The Producer / Sales agent deliver a copy of the Digital Cinema Master (DCM) to the Distributor. The Distributor then produces, with support of a Lab., the relevant number of digital files adding a dubbed version or/and subtitles if appropriate. These Digital Cinema Prints (DCP) are later distributed to the theaters.
 - o The distributor and exhibitor make an agreement about how and when a movie will be shown in a cinema, making agreements with many exhibitors.
 - o One or two weeks ahead of release, the distributor sends out the movie hard disks (or other delivery mechanism). The disk can either travel around so that each cinema can download it to its server, or more likely individual disks will be sent to theatres. The distributor (or trusted third party) sends out a virtual key to each cinema (physical or electronic send out) so they are able to screen the movie as per the agreement. New agreements can be made to accommodate move-overs or longer runs. The Digital Cinema Files can stay on the server in the theater unlimited as long as there is enough space on the server Hard Disc. For a new screening the Digital Cinema Files must be activated by a Key from the Distributor. If there is not enough

- space on the server Hard Disc, the Digital Cinema File will be erased and replaced by the file of a new movie.
- Down the line, the movie delivery will be electronic as will reporting and invoicing.

RISKS & ADVANTAGES

1. RISKS & DRAWBACKS

- Why is so few European content available in digital?
 - The producers & sales agents are not providing the encoding / producing of the Digital Cinema Master (DCM), or they are doing it at very high costs.
 - The encoding is still very expensive and still being paid by the distributors at the moment.
 - There is usually the necessity to also have a 35mm print to ensure the whole life of the film in a multiplex (since usually only one or two screens of the multiplex are equipped)
 - Independent distributors are facing a vicious circle: the digital screens are in big rooms of big multiplexes. Only big blockbusters can be booked in these screens, not independent or European movies until all the screens are equipped.
- For an independent distributor, the digital roll out means, currently, more costs:
 - **Very high Virtual Print Fee (VPF)**
 - The VPF usually costs between 600 and 750€, if a third party is incorporated.
 - The second run VPF rate is a reel problem: each time the film moves to a new cinema, the distributor will have to pay again a new VPF. With 35mm prints (≈ 1.000,- €) there are no new print costs when the print is brought to a new theater. The current VPF is more a “virtual booking fee” than a reel “virtual print fee” (the distributor has to pay for each booking of the film).
 - Cinemas are and will be equipped by multiple third parties: the distributor has and will have to pay a new VPF to each third party.
 - **Transition period: double cost digital/35mm**
 - It is necessary to provide screens that are digitally equipped and screens that are not.
 - It is usually necessary to have also a 35mm print to ensure the whole life of the film in a multiplex.
 - **Not just print costs but also other costs at the moment:**
 - Mastering costs
 - Delivery costs
 - Key generation costs (between 10€ and 80€)
 - New administration costs (for instance, managing of the keys, reporting and invoicing)
 - Commission of the third party if there is one (usually between 15% and 20%)
 - **Back Catalogue:**
 - Independent distributors usually have an important back catalogue and many of these films are still booked in theatres.
 - Independent distributors will lose a very important income from their back catalogue if every cinema turns to digital, or will have to spend a fortune in digital masters and digital prints.
 - Furthermore, **the proposed 10 years contracts by third parties** imply a very long financial engagement while during this period the setting of digital distribution may change completely. **And what about the next generation of equipment?** In 10 years, cinema might have to renew completely their equipments due to new technological progresses: who will then pay for it?
- General Drawbacks of digital cinema for distributors
 - **New comers:** The introduction of a new technology will inevitably lead to threats to existing film distribution companies. New entrants are likely to perceive digital cinema as an opportunity to enter a market, especially as it will lower financial barriers to entry for those players.
 - **Increase of the competition:** Wide releases may get even wider. This would see the popular blockbuster movies get onto even more screens than now, especially in the opening week. Will

there still be screen space for smaller films? Will it lead to even shorter runs as we have already now? Will it lead to even more released titles?

- **Higher turnover of films: The greater flexibility** in booking provided by digital (as there will not be a print commitment from an exhibitor) could lead to a model with **high film turnover** where word of mouth has even less time to have an impact. This will harm arthouse films disproportionately to more mainstream titles with their huge marketing power.
- **Higher Marketing Budgets:** since more films will be fighting for the same amount of screen space, this will result in distributors having to spend significantly more money on marketing campaigns, in order to make their film as visible as possible in a crowded market.
- **Digital practices as a challenge for independent distributors:**
 - Today: fixed amount of 35mm prints, the challenge is to book these prints the best way.
 - In digital the logic won't be the same :
 - Multiple actors : labs, third parties, transportation companies, key management companies etc
 - Multiple kinds of costs : VPFs, access fees, rental rate, key costs etc
 - each of these parameters will be different for each theater, and each film

- **Risks of the private (third party) schemes:**

Reminder: Arts Alliance, XDC and Ymagis have now signed VPF-inspired deals with US studios for European screens (around 7,000, 8,000 and 5,500 screens respectively)

- **Staggered and unmanaged roll-out with a longer transition period** (8 to 10 years at least)
- **Higher costs:**
 - Very high VPF: Distributors pay up to 75% of the investment for the digital roll out. This percentage is impossible for Independent Distributors.
 - Third-party takes a commission, which adds to global cost
- **Lack of transparency of the contracts:** the DG Competition of the European Commission and the European Investment Bank (EIB) have both underlined the problem of transparency in the current agreements with third parties.
- **Risk to small cinemas as less viable economics:** digital releases may exclude some smaller arthouse exhibitors, i.e. exhibitors which make a regular work on cultural diversity and program movies of independent distributors but don't have enough first runs.
- **Concentration risks :**
 - When a third party has equipped a large number of screens in a country, binding the theater exclusively to the third party, the distributor will have no choice but to sign an agreement with a third party and to pay a VPF.
 - Also, the weak spot with third parties is that the films running in circuits equipped by third parties have to be furnished by third parties; every other film outside the circuit will be charged a higher amount from third parties.
 - **Danger of vertical concentration:** the third parties want to control all the cinema chain, from digital postproduction to digital equipment. This could lead to the emergence of new networks based on technical distribution. Third parties could hence become Distributors themselves.
- **High turnover of the movies:** the **third party model might lead to an acceleration of the film rotation in theatres.** The more films the cinemas run, the more VPF they get, and the faster the equipment costs can be recouped.
- **All changes are currently determined by American majors and commercial exhibitors:** Independent - at least at this stage - seem to have no real place in the decision making: who has got the financial strength to invest, simply invest.

2. **ADVANTAGES OF THE DIGITAL WORLD**

- **Cost savings for the distributors:**
 - Prints once the roll out is over:

- Current 35mm Print costs: 600-800€ for a wide release and maybe around 2,000€ for a limited release
- There will still be a cost of a print in a digital world, although it will be significantly lower. Therefore an important saving off the costs of a wide release, and significantly proportionally more for a limited release.
 - Subtitled movies
 - Physical distribution costs when the file is sent by satellite rather than on hard drives
 - Small saving in the destruction of physical copies : the hard drives can be re-used rather than being destroyed as is the case at present.
- **Cost savings for the exhibitors:**
 - Prints assembly
 - Decrease of salary charges, especially in big cinema chains (the projectionist might also be the cashier...)
- **Wider releases for smaller films**
 - Given significantly cheaper print costs, a smaller film could be released more widely than now, assuming it can find the screen space to do so and afford the additional VPF costs.
 - This can mean that the marketing of a film can be made more effective, with the buzz of initial release being exploited in many more cinemas.
- **Flexibility :**
 - **Of the programming** (flip side of the risk mentioned above): if films prove successful after a small initial commitment, cinema could bring the film back to play again and again building through word of mouth. Smaller films will hence have the ability to stay in a cinema for much longer, as that print will not need to be moved onto another cinema.
 - **Of the subtitles:** possibility to present a majority of foreign film works in their original language versions without bringing about considerable additional costs for creating special 35mm copies.
- **Perfect quality after numerous screenings** (it matches the original): screenings don't affect the quality, audio is not compressed. Cinema in this way could regain its “spectacular” nature: big screen, perfect audio and image quality, 3D.
- **Opening of new possibilities to the film repertoire**
- **New possibilities to the cost effective production of film versions with sound / subtitles** for potential cinemagoers who have bad eyesight or poor hearing.

PROPOSALS

1. GLOBAL PRINCIPLES

- **Independent Distributors release most European and art house movies. They don't want all the changes be determined by American majors and commercial exhibitors They want to have a real place in the decision making.**
- **The digital roll out must not worsen or threaten:**
 - The diversity of programming
 - The existence of independent companies in Europe (producers, distributors and exhibitors)
 - The established relationship between exhibitors and distributors
- **The digital roll out must be:**
 - Transparent
 - Structured
 - Based on a short term period for its financing

- **There is the necessity of inventing new models:**
 - o The mainstream model (such as the VPF model implemented by the US Studios) is taking hold, but may not respond to all types of exhibitor or distributor and this is where government could intervene.
 - o In the current schemes proposed by third parties, not only independent distributors and producers are not saving money, but they are losing money. Savings are expected in 10 years: this situation might be appropriate to major companies but it means the end of independent distribution as such if independent distributors have to carry the costs of the digital transition.
 - o We think that different models may be needed for different market strata, and we believe in the “solidarity” approach that includes public models.

- **The digital roll out models will be national, not Pan-European**
 - o We know that it is very hard to elaborate a pan-European model for the financing of the digital equipment of European screens, as the European national markets are indeed very diverse.
 - o The Media Program and the EIB have announced that they would intervene in addition to the national or regional supports.
 - o Nevertheless, we think that it is important that European authorities look carefully that the current business models implemented in Europe do not negatively impact competition (for instance in the agreements signed by third parts with American Majors) or result in a dominant market position (the example of Portugal and Lusomundo is interesting in regards to this issue); otherwise there is a clear need for market regulation.

- **Alternative content should not exceed 5% of the global programming of a cinema.**

2. FINANCING THE ROLL OUT

- **Public money (National, MEDIA, Regional...) is strongly needed:**
 - o A public scheme is necessary because it will enable a managed roll out and minimise the transition period. Also, public schemes are not motivated by profit which will keep costs down.
 - o Public money is the only guarantee that no cinemas, even the smaller ones or the ones with a low turnover but a high quality programming, will be left behind and that no independent distributors disappear because they cannot afford to pay VPF.
 - o If public money could invest at least 40% as a subsidy to exhibitors (so that they can own their material just as they own any other technical equipment), distributors and exhibitors could find a solution together to implement the roll out (it's already the case in some countries).

- **The contribution of distributors to the financing of the digital roll out must be:**
 - o Based on a short term period
 - o Based on a reasonable and proportionate amount.

- **New costs:**
 - o 2K master:
 - Sales Agents must have a dialogue with producers to ensure that 2K masters are available to distributors. Distributors should also try that the access to digital master is guaranteed by the sales agent when they buy a film. *(Reminder: Producers can be supported by Public fundings like Eurimages (Enveloppe = 500 000€) for the creation of digital masters but no one uses this fund)*
 - In the mean time, European distributors should work more together on creating digital masters (i.e. such as the D Platform project).
 - o New eligible costs related to digital releases should be incorporated in the agreements distributors sign with sales agents so that these costs can be put in the P&A.

- Keys: Distributors should not have to pay more than a few cents for the generation and managing of the keys.
- **We need other sources of financing for the equipment:**
 - Cinemas are not only winning money with movies, but also with advertisements, sweets and candy...
 - In addition, advertising production companies will also save a lot of money with the disappearing of prints.
- **Transition Period needs to be as short as possible:**
 - **All screens in a cinema need to be digital** or a further set of problems are created. In a hybrid world the cinema may be able open on Digital but then would need 35mm for the film to continue in a smaller screen. This is why a public scheme that enables a managed roll out with a short transition period is necessary.
 - To keep interest costs as low as possible and to realize a reasonable installation period, **we suggest a period between 3 and 5 years** (depending on the country size) during which the installation and financing of the entire park should be carried out. Only this way can the cost-intensive hybrid operation of analogue and digital copies for distributors and producers be maintained within a clear framework.