



Movie markets in the UK

Annex 11 to pay TV market investigation consultation

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Annex 11

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This annex contains an Ofcom-commissioned independent report produced by Screen Digest which provides an overview of the UK industry for television rights for movie content, including:

- Types of rights bought and sold for distribution in the UK
- Relationships between broadcasters and rights holders in the UK
- The way rights have been sold in the UK

Movie Markets in the UK

A report commissioned by
OFCOM



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1 Executive summary

Overall market trends

1. Screen Digest has segmented the analysis in four movie markets and ten sub-markets, or windows, according to the table below. 'Free-to-view television' addresses movies on both free-to-air channels and basic cable/satellite channels, which are sharing the same rights window.
2. At retail level, British consumers spent £3,595m on movie products and services in the UK in 2006, which is approximately three billion pounds (£3,060m) net of VAT. Spending hit a record high in 2004 at £3,155m (VAT-net) but since then, a decrease in DVD spending has driven the total market down. We expect the market to reverse the decline over

the forecast period however, to reach £3,403m in 2010.

3. The DVD market is the largest of those assessed in this report, by some margin. In 2006 it represented 56 per cent of all spending (£1,655m), with DVD retail (high street and online) alone representing the bulk of that total amount (£1,323m). This is in spite of a decline in the DVD market. Spending on the format has fallen in recent years from a record high of nearly £1.8bn in 2004, due largely to ongoing reductions in DVD prices.

4. The second biggest market is pay TV, which generated an estimated £673m in subscription fees to Premium Movie channels (Sky) in 2006. Cinema comes third, with £649m in 2006 (21 per cent of total spending).

5. Cinema, DVD and pay TV are all mature markets, therefore Screen Digest expects them to grow at a slow rate in the next five years.

6. By contrast, the 'on demand' category – Internet-based and TV-based 'video on demand' services – is in its infancy so is the only segment where there is room for significant growth. This segment of the UK movie market generated £84m in 2006, accounting for just 3 per cent of total spending. Screen Digest expects spending in the 'on demand' category to treble in size to reach £245m in 2011, expanding its share of total spending to 6 per cent. Growth will be driven primarily by true-VOD on cable/IPTV

Figure 1: Segmentation of movie markets and colour code

Cinema
Total Cinema
Retail - High Street DVD
Retail - Online DVD
Rental - High Street DVD
Rental - Online DVD
Total DVD
Walled Garden VOD (or TV-VOD)
Internet VOD ('rental')
Internet Download-to-Own (or 'digital retail')
Total On Demand
Premium Pay TV Movie Channels
Free-to-view Television

and Internet-based digital retail ('download-to-own').

7. At business-to-business level, UK-based distributors (theatrical distributors, DVD wholesalers and publishers) received £1,935m from the exploitation of their rights in the UK, from all windows. This translates into 63 per cent of the £3,060m spent by consumers, after VAT has been deducted.

7-1. More than half of this was generated by DVD (£1,104m, 57 per cent of the total), with pay TV the next largest contributor (£313m, 18 per cent), followed by cinema (£266m, 15 per cent) and Free TV (£199m, 11 per cent). Revenues from on-demand exploitation totalled just £54m (2 per cent) in 2006 but it will be the fastest growing segment in the next five years, reaching about £159m in 2011 according to our forecasts (8 per cent).

8. Finally, at studio level, Screen Digest estimates that movie rights-holders earned a net £1,083m from the UK movie markets in 2006 after UK distribution margins and costs (£852m) are removed from the gross £1,935m distribution revenue.

8-1. Again, the bulk of this amount is derived from DVD, with DVD retail alone generating £523m (48 per cent). Television – where no specific distribution costs apply – makes a similar contribution at £512m (47 per cent). Cinema – where Print & Advertising ('P&A') marketing expenses are huge (£306m in 2006) – actually makes a net loss from a studio

point of view: -£40m in 2006. Structurally, theatrical distribution is not profitable and is in fact considered a 'loss-leader' by US Studios. Theatrical distribution is considered an investment, designed to build momentum for titles in order to maximise revenues further along the value chain, especially in the DVD window which follows cinema. Even in 2004, which was a good year for the box office, the net revenue of studios was nil.

9. The proportion of retail-level consumer spending that movie studios retain has been evolving over the last few years:

- DVD is the most profitable distribution channel, as studios get 55 to 60 per cent of net spending
- Studios receive around 50 per cent of net VOD revenues
- Their share of nascent Internet-based digital rental is about 31 per cent of net revenue. Like traditional retail, digital retail - 61 per cent of net revenue – offers high returns in relative terms, making it potentially the most profitable market of all
- The proportion of UK pay TV movie spending secured by studios has declined significantly, mostly due to effective re-negotiations of output deals by BSkyB in 2004-2006.

10. In terms of exploitation windows, the traditional sequential windows system still prevails. Digital outlets tend to find their natural place in this ecosystem. For instance

Figure 2: Summary of movie windows in the UK

	Window starting...	Typical/average price	Concentration of Operators
Theatrical Release (cinema)	0	£4.78 per movie	Medium (top 5 circuit=80% BO)
DVD rental (high street or online)	4 months (17weeks)	£2.94 per movie	Low
DVD retail (high street, online, digital)	4 months (17weeks)	£9.46 per movie	Low
VOD (nVOD or true VOD)	6 to 7.5 months	£3.50 to £4.00 per movie	High (near duopoly Sky/Virgin Media)
Internet-based download	6 to 7.5 months	£3.50 to £4.00 per movie	High initially (LoveFilm) but potentially low
Pay-TV subscription channels	12 months	£17-£18 per month	High (BSkyB having exclusive rights deals with all studios)
Free to view channels	24 to 27 months	Free	Medium - Decreasing (more FTV channels showing movies)

Source: Screen Digest

digital retail (download-to-own) will share the same window as DVD retail and digital rental will share the same window as existing TV-based VOD.

11. However, studios have exerted increasing pressure in the last few years to shorten windows in an effort to maximise returns from the windows that are most profitable:

- In 2002 the exclusive DVD rental window was abolished, with titles being released on DVD for retail and rental simultaneously.
- The theatrical release window has been narrowed significantly, from 31 weeks to 19.5 weeks on average between 2002 and 2005. Exhibitors subsequently agreed a minimum window of 17 weeks with distributors
- Some distributors are attempting to bring the DVD window even further forward
- Some US Studios have publicly supported the simultaneous release of titles across cinema, DVD and VOD platforms.

12. In the sections of the executive summary that follow, we look at the key findings and trends for each window/market.

Cinema

13. The UK cinema market has matured, characterised by high density of multiplex screens and concentration among leading cinema providers. There were 3,569 screens at end 2006, of which 70 per cent were multiplex (five or more screens per cinema). By 2011, we anticipate a net increase of just four per cent to 3,714 screens.

14. Average admissions per capita in 2006 were 2.6, and are struggling to break the three times average frequency. The most recent high for cinema admissions was in 2002 at 176m, thereafter the market has plateaued. Over the last few years, growth has been driven mostly by ticket price inflation rather than an increase in consumption. UK cinemagoers spent £648m (VAT net) in 2006 based on an average ticket price of £4.78 and 156.6m admissions.

15. There were a total of 505 first-run theatrical releases in 2006, representing an additional 151 films compared with the corresponding total in 2001 (354). The number of film releases of US origin has also been increasing although still accounting for a similar proportion of the total market.

Typically US films account for around 35 per cent of releases and up to 80 per cent of box office. In 2005, there were 189 films from the US (including co-productions) compared with 115 in 2001.

16. We estimate that UK theatrical distributors receive around 41 per cent of net box office revenue - equivalent to £266m in 2006 - from which they have to recoup their print and advertising costs. After distribution costs are factored in (which amounted to a record £306m in 2006), the net revenues made by movie studios are reduced to very little, if anything. This has led some to consider cinema as a 'loss leader' or cost centre window from the point of view of studios. The UK theatrical distributors that are affiliated to US Studios have a market share of more than 80 per cent.

17. By 2011, we expect box office sales to grow to £842m, driven by modest inflation in ticket prices. The market will be stable thanks to incremental rises in cinema attendance and the positive impact of digital cinema.

18. Agreements between theatrical distributors and exhibitors are known as 'rentals' and stipulate revenue sharing terms on a strictly film-by-film basis. There are three different types of 'rental' agreements: 'sliding scale', 'house nut' and 'specialised'. The exhibition market is quite concentrated: the top five cinema chains account for 80 per cent of box office and 70 per cent of cinema screens.

19. Digital projection is now being rolled out. It will reduce costs in the value chain and is also expected to provide a boost due to increased flexibility, as well as more and varied content services (including non-movie content and economical projection of 3D movies).

DVD

20. The DVD market can be broken down into four sub-sectors or business models: offline high street retail, online retail, offline high street rental and online rental.

21. In 2006, films represented 72 per cent of the £1.3bn (VAT-net) spent on DVD retail (online and offline). On the rental side, virtually all offline spending was on film (£289m) but within the online rental space, film accounts for around 75 per cent of

spending (£43m). We estimate that movie rights-holders get almost 60 per cent of consumer revenue (VAT-net).

22. At the end of 2006 there were 20m households equipped with a standalone DVD player/recorder. Average buy rates (the annual number of transactions per DVD household) in the offline sectors are declining but remain significantly higher than those in the online markets.

23. All four DVD sectors share a unique release window. On average, titles are launched on DVD around 19 weeks after their cinema release, the minimum being 17 weeks.

24. HMV and Play are the biggest players in the DVD retail market's respective offline and online sectors. On the rental side, Blockbuster (offline) and LoveFilm (online) are the top principal providers. Wholesalers EUK and Handleman are important middle-men in this market, on the retail side at least. Between them they represent almost three quarters of all wholesale shipments to DVD retailers.

TV-based VOD (walled-garden VOD)

25. 'TV-based' or 'Walled-Garden' VOD services (as opposed to Internet-based VOD) can be broken down into nVOD services (BSkyB) sometimes also referred to as 'PPV', and 'true-VOD' services (available on IPTV since 2000 and on cable since 2005).

26. Both TV-based VOD platforms share a release window with Internet-based digital rental. The PPV/VOD window opens as soon as six months after theatrical release. All VOD operators can negotiate for access to studio catalogues on a non-exclusive basis.

27. Currently around 11m UK households can access nVOD or VOD, rising to almost 15m in 2011. Average buy rates are much higher for true VOD than nVOD (seven titles a year compared to 1.5 on nVOD). Thus the shift to true VOD has resulted in growth for the whole category. Of the £248m (VAT-net) spent by UK consumers in 2006 on VOD services, £83m was spent on movies, with £78m of that spent on 'recent' movies.

28. By 2011 we expect movie spending to grow to £162m (of which £145m will be accounted for by recent movies) out of a total VOD spend of £555m. However, we

expect buy-rates and growth to be offset by competition from Internet-based VOD, from 2008-2009.

29. Two VOD operators, Sky and Virgin Media form a near duopoly today (98 per cent market share). Other players (BT Vision and Tiscali TV) are likely to capture up to 20 per cent market share by 2011. FilmFlex is an important technology enabler and aggregator in this VOD market, managing the back-end for cable, and negotiating rights with all US Studios (by contrast BSkyB is dealing directly with Studios). We estimate that movie rights-holders get approximately 50 per cent of the VAT-net consumer revenue, which translates into about £40m in 2006.

Internet-based VOD

30. The market for 'Internet-based' or 'open gateway' VOD (as opposed to TV-based, walled-garden VOD) can be segmented into four sectors: digital rental, digital retail or 'download-to-own', free or 'ad-supported' and subscription. It is anticipated that digital rental will ultimately replace physical DVD rental and challenge walled-garden VOD/PPV, whilst digital retail is expected to challenge DVD retail.

31. Digital retail shares the same window as DVD, with some new releases arriving 'day and date' with DVD, as little as 17 weeks after their theatrical debut. Digital rental shares a window with its TV equivalent, traditional VOD/PPV. The window for free or 'ad-supported' VOD over the Internet sits alongside free-to-air TV. Internet-based subscription VOD borrows its business model from pay TV so sits in the same place in the value chain.

32. Around 12m UK households are currently equipped to access these services via a broadband connection. However, average buy rates were less than one transaction by year for both retail and rental sectors in 2006 and are expected to remain this low over the forecast period.

33. Internet-based rental and retail are nascent: we estimate that UK consumers spent £500,000 on Internet-based VOD in 2006. In 2011 we expect annual digital rental spending to have risen to £7m and annual digital retail spending to have grown to £76m. Movie rights-holders secured an estimated 26 per

cent of digital rental spending and 50 per cent of digital retail spending in 2006.

34. LoveFilm dominated both retail and rental sectors in 2006 but many other players are expected from various sectors in the long term: technology companies (e.g. Apple, Microsoft), pay TV companies, aiming at protecting their VOD window, ISPs and portal (e.g. AOL, BT) in order to reduce churn and increase 'content' revenue, entertainment retail specialists (e.g. HMV, Virgin),etailers (e.g. Amazon). Even independent players and production companies aiming to cut out the 'middle men' are potential entrants as there are relatively few barriers to entry.

Premium TV

35. Within the pay TV sector, only one company – BSkyB – offers premium pay movie services direct to the public. The pay TV window starts 12 months after cinema release and lasts 12 to 18 months before the free-to-air window starts. BSkyB acquires and transmits library movies and first-run titles (about 2,500 movies per year in total).

36. In line with most pay TV platforms, BSkyB is understood to licence films for pay TV for a maximum of three years. Sky has ongoing exclusive supply agreements (output deals) with all of the major Hollywood Studios and a number of independent production companies. The pricing of contracts is principally defined by the number of premium pay subscribers and the value of a given movie by its performance in terms of box office.

37. Today more than 5m (about two thirds) of Sky Digital subscribers take the premium Sky Movies package (costing £17 to £18 per month, in addition to basic subscription fees, depending on subscription combinations), but we anticipate that proportion will slightly decline in the future as consumers have access to alternative movie sources.

38. Of the £673m of subscriber revenue that can be attributed to premium movie channels in 2006, BSkyB paid an estimated £313m (47 per cent) to rights-holders.

Free-to-air TV

39. The number of film transmissions on the five major terrestrial channels has declined

significantly in the last decade, as movies are no longer achieving top audience ratings. Having said that, digital free-to-view channels are now showing movies as well. Although blockbuster films can still deliver mass audiences, broadcasters are highly selective in acquiring first-run US titles. Compared with other genres of programming, films are not seen as cost-effective.

40. The free-TV window usually starts 24 to 27 months after cinema release, but for independent films it can be less. Movies deals between studios and broadcasters can follow several models: output deals (not as common in free TV as they are in the pay TV sector), volume deals (limited to a certain number of films), and title-by-title deals (for library and independent titles mostly). Pricing is typically negotiated as a percentage of the UK box office performance – the percentage varies according to the genre of the movie and the audience of a given channel.

41. Studio sales to free-to-air television – estimated to be worth £199m in 2006 – are significantly lower than those coming from pay TV (£313m). In the future we anticipate that higher competition on the buying side due to the launch of new free-to-air digital channels – Film Four, Five US, and the ITV film channel among them – will compensate for the reduction of film output on terrestrial channels and decreasing audience ratings thereby maintaining (or even slightly increasing) the size of this market.

2 Overall market trends

2.1 Introduction: value chain structures and terminology

41-1. In this report, we identify three generic levels in the respective movie value chains:

- **The production level or 'studio' level**, comprising movie production companies either US 'majors' (e.g. The Walt Disney company), or 'independent' companies. This value level of movie providers also include 'catalogue' players who do not have a strong production activity but manage large libraries. The term 'movie rights-holder' encompasses all these categories of movie rights providers.
- **The UK distribution level**, or business-to-business (B2B) level, comprising sector-specific types of players and specific terminologies (e.g. Buena Vista home video UK, FilmFlex, see table below).
- **The UK 'retail' level**, or business-to-consumer level, comprising theatrical

exhibitors, high street DVD retailers, DVD rental chains (or 'rentailers'), digital retailers (e.g. LoveFilm).

41-2. In the industry, the term 'distributor' can be used to refer to both B2B and B2C levels. In this report, for the sake of clarity, we will generally use 'distributor' to refer to the middle B2B level, whilst using 'retail' generic terms for B2C level, or the sector-specific terms (e.g. 'exhibitors').

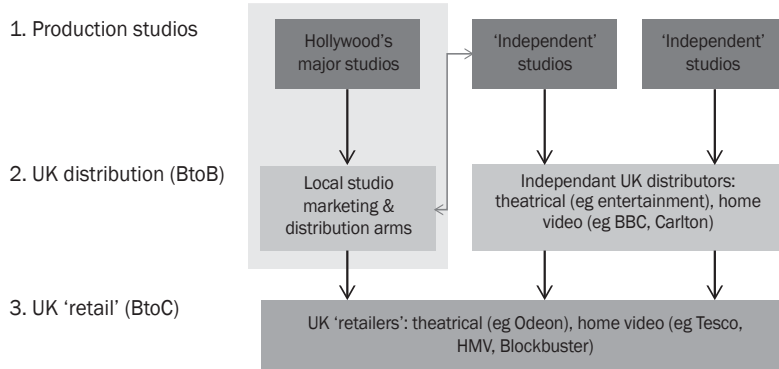
41-3. In addition to the players' categories mentioned in the above table, there are third party players that are specific to some distribution chains. For instance: physical distributors in the cinema value chain, and wholesalers in the DVD sector. However, these players are sometimes purely logistical service providers and in any case they do not play a significant role in the value chains.

41-4. The value chain levels described above are common to the theatrical and home

Figure 3: Movie value chains

Generic terms for value chain levels	Examples of window-specific terms and entities			
	Cinema	Home Video (DVD)	VOD	Pay TV
1. Production or 'studio' level (global)	Hollywood Studios: eg. The Walt Disney Company/Buena Vista International			
2. UK distribution level	Theatrical distributors: BVA UK	Video publishers: BV Home Video UK	FilmFlex	
3. UK 'Retail' level	Exhibitors: Odeon...	Retailers, rentailers: HMV, Blockbuster	VOD operators: Sky, Virgin Media	Pay TV operators: Sky

Source: Screen Digest

Figure 4: The three generic levels in the movie value chains 1

Source: Screen Digest

video sector. In both markets for instance, Hollywood major Studios are vertically integrated with local distribution arms. The television and on-demand sector is slightly different. Because this is a rights market, no specific distribution/marketing structures are needed. Pay TV operators and broadcasters are directly negotiating with studio sales representative based in Europe or in the US.

Focus on Hollywood 'Studios'

41-5. 'Studio' is a generic term used to refer to a film production company. When referring to the six 'major' Hollywood Studios, we use a capital 'S'. In this more specific sense, 'Studio' can refer to both the Hollywood-based mother companies and/or their European arms/subsidiaries that operate the marketing and releases of titles locally - to differentiate them from other local, independent distributors. As a general rule, all Studio-produced movies are locally distributed by their vertically-integrated local distribution arms, for cinema and home video. However in the consolidated table we keep a consistent distinction between the former and the latter.

41-6. The biggest source of movies in the UK, for all windows, are the US major Studios. More generally, Hollywood Studios play a central role in the movie value chain and the distribution of movies in the UK.

41-7. Up until the 1950s, major Studios were fully vertically integrated companies doing in-house production featuring exclusive stars and creative personnel, fully-owned distribution arms right down to theatres. After the post-war anti-trust Supreme Court ruling (1948), the 'system' was dismantled. Today there are hardly any corporate links with exhibition left, but the vertical integration of distribution

worldwide remains at the core of the business model.

41-8. Today the term 'major' still refers to Hollywood motion picture companies, descendant of the historical Studios and the associated catalogues, and still specialised in the distribution of major 'blockbuster' films. Films may be produced in-house, or by affiliated production companies. Even when these production companies are independent in corporate and artistic terms, the Studio plays a central role in the development and financing of their projects and normally gets US and worldwide distribution rights.

41-9. At present six American companies are considered 'major' Studios. They are the only members of the Motion Picture Association of America (MPAA), a lobby that is active from Washington to Brussels.

1. Buena Vista Pictures Distribution (The Walt Disney Company);
2. Paramount Pictures Corporation;
3. Sony Pictures Entertainment Inc.;
4. Twentieth Century-Fox Film Corporation;
5. Universal City Studios LLLP; and
6. Warner Bros. Entertainment Inc.

41-10. The seventh historical Studio, MGM, is now controlled by Sony (20 per cent stake, the rest being owned by Comcast and financial shareholders). However, it was decided to keep distribution separate from Sony Pictures for the time being. In practice, films produced under the MGM label are to be distributed theatrically on a film-by-film basis. Last year in the UK, Sony UK released MGM's *Casino Royale* but other MGM films were released by the UK independent distributor Entertainment.

41-11. New Line Cinema is another 'independent' company, controlled by a Major Studio (Time Warner), but without a distribution agreement with Warner Bros. In the UK in 2006 New Line films were released by Entertainment.

41-12. Similarly, Dreamworks SKG is now part of the Viacom/Paramount group, Dreamworks' blockbusters are to be released overseas by local Paramount or UIP outlets (e.g. in 2006 in the UK Dreamworks' Munich was distributed by UIP) while some 'specialised' films may still be distributed by specialised independent distributors.

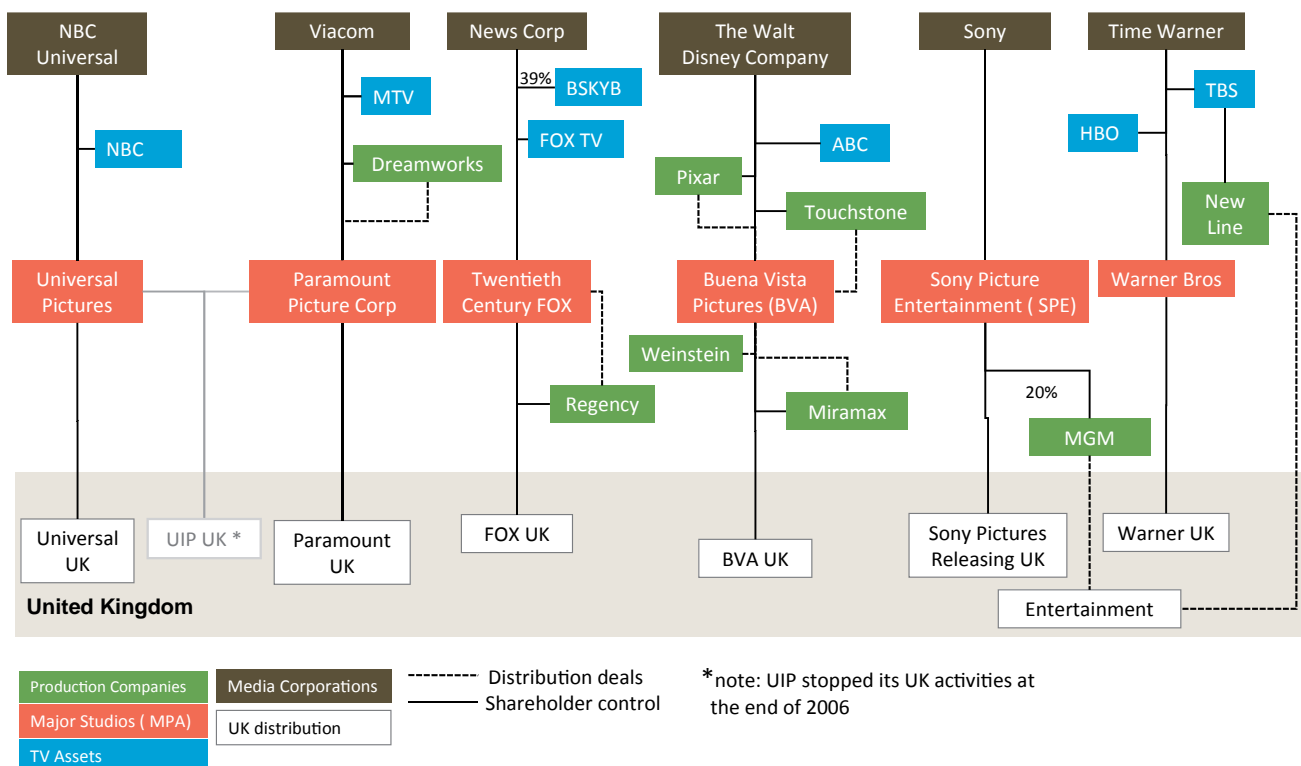
41-13. All major Studios normally have their own distribution subsidiaries in each country, which release all their in-house blockbusters and some local acquisitions: one for theatrical distribution; one for home video. In some countries, Studios have been using the 'Universal International Pictures' (UIP) joint-venture between Universal and Paramount, for their theatrical operations, despite the scrutiny of the European Commission, to which it has given certain undertakings to guard against anti-competitive behaviour. In the UK, UIP ceased to operate at the end of 2006, and from now on Universal and Paramount will release their titles independently with ad hoc distribution teams.

41-14. Theatrical and home video distribution teams are more or less integrated in management and marketing terms, depending on national structures and history. They may or may not share common management at national level.

Television and VOD deals tend to be negotiated directly with Hollywood-based executives.

41-15. Whatever definition or method is used to assess it (origin of the films, integrated distribution or not), the market share of the Studios is well beyond 80 per cent in all UK windows.

Figure 5: Mapping of US Studios and their UK theatrical distribution



Source: Screen Digest

2.2 Market size: consumer-level spending (retail/rental revenues)

42. Consumer spending on movie products and services in the UK in 2006 was approximately three billion pounds (£3,060m) net of VAT. The record year was 2004, when consumers spent £3,155m, but since then a decline in the DVD market has pulled total spending down.

43. The biggest market is the DVD market, by a large margin. It represented 56 per cent of total movie spending in 2006 at £1,655m. DVD Retail (including online retail) represented the bulk of that total (£1,300m). Average price falls have resulted in the value of the DVD market falling from a historical height of nearly £1.8bn in 2004.

44. The second biggest market is pay TV, with an estimated £673m spent in subscription fees to Premium Movie channels (Sky).

45. Cinema comes third, with £649m in 2006 (21 per cent of total spending).

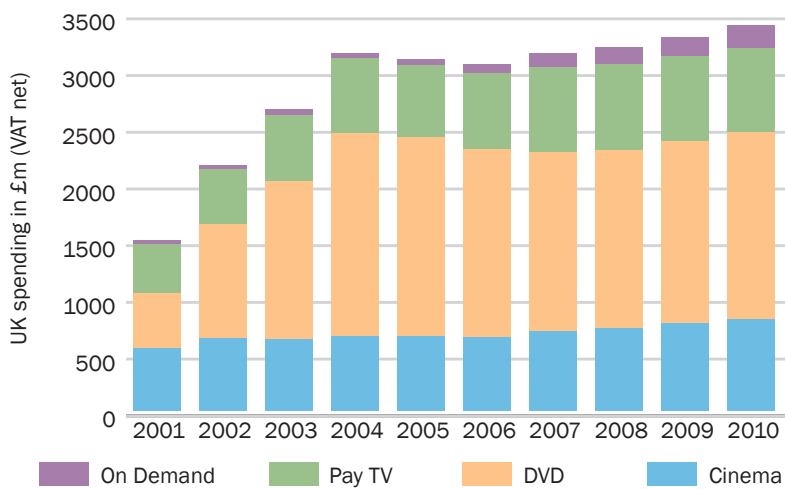
46. Each of these markets has matured, therefore we expect them to grow at a slow rate between 2007 and 2011. By contrast, the 'on demand' category – Internet-based VOD (rental and retail) and TV-based VOD – is a developing market so will grow significantly. We expect spending in this sector to treble over the forecast period, from £84m in 2006 to £245m in 2011. Growth will primarily come from true-VOD on cable/IPTV as well as Internet-based digital retail (download-to-own).

Figure 6: Overview—Consumer spending on movies in the UK, by window

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Cinema (A)	549	643	631	655	661	649	699	727	768	805	842
Retail - high street DVD	399	771	1,026	1,269	1,189	1,069	1,030	1,018	1,032	1,057	-
Retail - online DVD	37	88	136	198	210	254	245	242	245	251	-
Rental - high street DVD	55	141	228	318	321	289	252	235	228	227	-
Rental - online DVD	-	1	2	10	29	43	55	75	100	117	-
Total DVD (B)	491	1,000	1,393	1,796	1,748	1,655	1,581	1,570	1,605	1,652	-
Walled gardened VOD	34	38	47	50	57	83	118	139	145	153	162
Internet VOD ('rental')	-	-	-	-	0	0	1	2	3	5	7
Internet VOD ('retail')	-	-	-	-	-	0	2	7	23	47	76
Total on demand (C)	34	38	47	50	57	84	120	148	171	205	245
Pay-TV channels	428	487	584	654	637	673	754	760	753	740	723
Free to view television	-	-	-	-	-	-	-	-	-	-	-
Total Broadcast TV (D)	428	487	584	654	637	673	754	760	753	740	723
Grand total	1,503	2,168	2,656	3,155	3,103	3,060	3,155	3,205	3,297	3,403	-

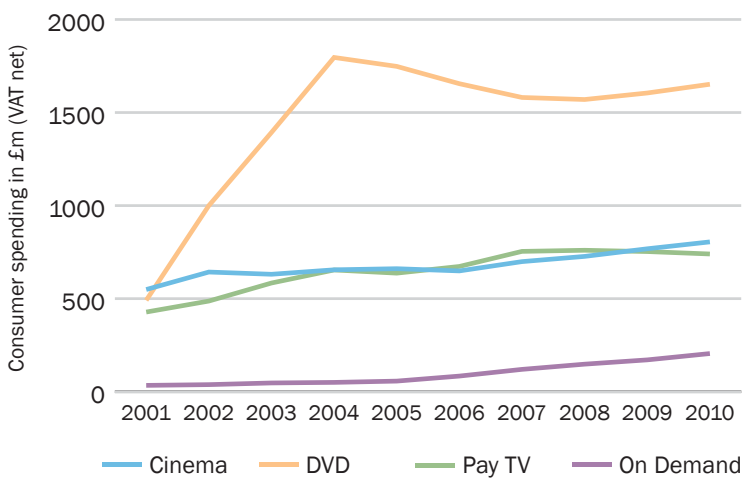
Source: Screen Digest

Figure 7: Total consumer spending on movies, by window (2001-2010)



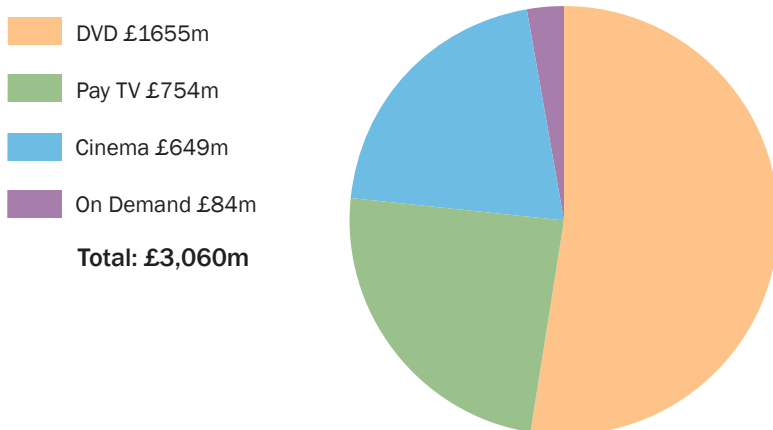
Source: Screen Digest

Figure 8: Consumer spending on movies, by window (2001-2010)

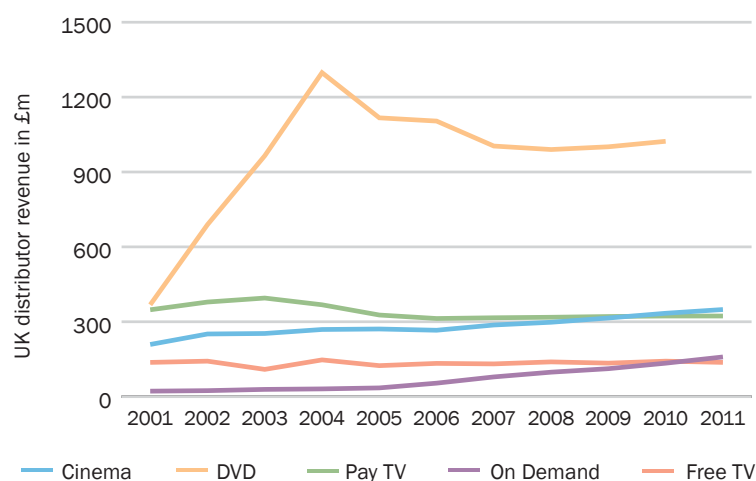


Source: Screen Digest

Figure 9: Breakdown of movie consumer spending in 2006 (£m, VAT net)



Source: Screen Digest

Figure 11: Overview - UK Distributor revenues by window

Source: Screen Digest

2.3 Market size: UK distribution revenues

47. In this section, 'distribution' refers to the players at B2B level (see section 41-2 for a definition). UK distributors received £1,935m last year from the exploitation of their rights in the UK, from all windows, after retailers' margins are factored in.

48. The bulk of this came from DVD retail (£845m, 57 per cent of the total), then pay TV (£313m, 16 per cent), cinema (£266m, 14 per cent) and free TV (£199m, 10 per cent).

Figure 10: Overview - UK Distributor revenue (£m, 2001-2011)

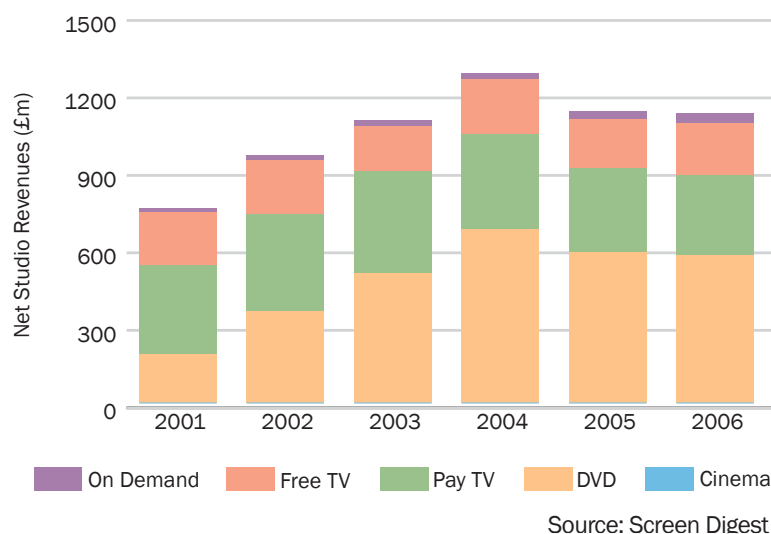
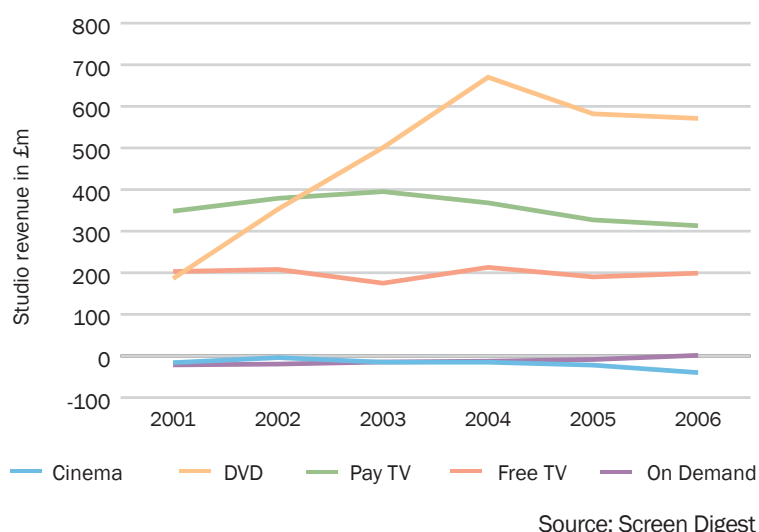
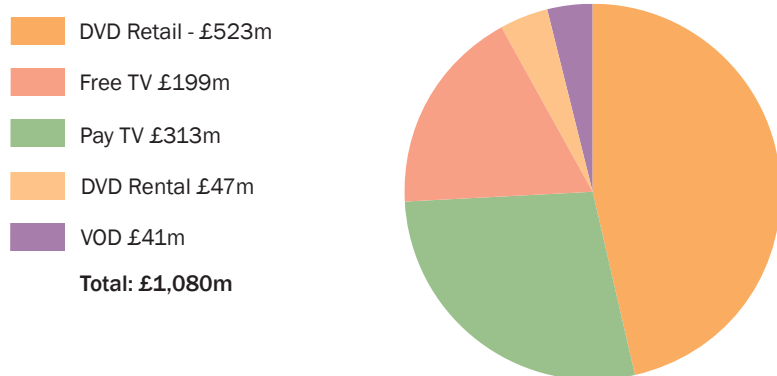
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Cinema (A)	209	251	253	269	271	266	287	298	315	334	349
Retail DVD	323	584	791	1,054	882	845	766	757	767	786	-
Online DVD	30	66	105	164	156	201	182	180	182	187	-
Rental	14	38	69	80	80	58	56	52	51	51	-
Total DVD (B)	368	689	965	1,298	1,117	1,104	1,004	990	1,001	1,023	-
TV VOD	22	24	29	31	35	54	78	93	97	103	109
Online VOD	-	-	-	-	0	0	0	1	1	2	2
DTO	-	-	-	-	-	0	1	4	15	29	48
Total on demand (C)	22	24	29	31	35	54	79	98	112	134	159
Pay-TV	348	379	395	368	327	313	316	318	321	323	323
Free TV	203	208	175	213	190	199	197	205	200	208	203
Total TV (D)	551	587	570	581	517	512	514	523	521	530	526
Grand total	1,149	1,550	1,817	2,178	1,940	1,935	1,883	1,909	1,949	2,022	1,034

Source: Screen Digest

Figure 12: Overview - Distributor revenues as a proportion of net retail

	2001	2002	2003	2004	2005	2006
Cinema	38%	39	40%	41%	41%	41%
Total DVD	64%	59%	60%	62%	55%	57%
Walled Gardened VOD	52%	53%	53%	54%	54%	49%
Internet VOD					31%	31%
Internet DTO						61%
Pay-TV	81%	78%	68%	56%	51%	47%

Source: Screen Digest

Figure 13: Studio-level net revenues (2001-2006)**Figure 14: Studio-level net revenues (2001-2006)****Figure 15: Studio-level net revenues - Breakdown by window (£m, 2006)**

49. Revenues from on-demand exploitation were only £54m (3 per cent) in 2006 but this will be the fastest growing segment in the next five years, reaching about £159m in 2011 (close to 15 per cent).

2.4 Market size: studio-level revenues

50. By taking into account the costs and margins of UK distribution (e.g. print and advertising costs in cinema), we can assess the net revenues made by rights-holders (movie production studios) from UK exploitation.

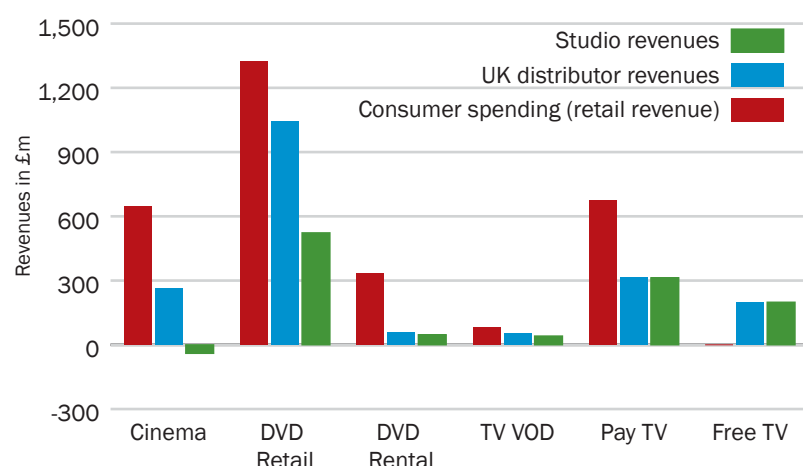
51. Movie studios made a total of £1,080m in 2006 from the exploitation of their rights in the UK across all windows.

52. DVD was the biggest contributor (£523m, 53 per cent of the total), followed by pay TV (£313m, 29 per cent) and free TV (£199m, 18 per cent).

53. Revenues from on-demand exploitation were only £41m (4 per cent) in 2006.

54. The proportion of consumer spending that movie studios get has been evolving over the last few years:

- DVD is the most profitable distribution channel, as studios get 55 to 60 per cent of net spending
- Studios receive around 50 per cent of net VOD revenues
- Their share of nascent Internet-based digital rental is about 31 per cent of net revenue. Like traditional retail, digital retail - 61 per cent of net revenue - offers high returns in relative terms, making it potentially the most profitable market of all
- The proportion of UK pay TV movie spending secured by studios has declined significantly, mostly due to effective re-negotiations of output deals by BSkyB in 2004-2006.

Figure 18: Overview - From retail revenue to net studio revenue (2006)

Source: Screen Digest

Figure 16: Overview - From retail revenue to net studio revenue (2006)

	Consumer spending (retail revenue) £m	UK distributor revenues £m	Studio revenues £m
Cinema	649	266	-40
DVD Retail	1,323	1,046	523
DVD Rental	332	58	47
TV VOD	83	54	41
Pay TV	673	313	313
Free TV	0	199	199
Grand Total	3,060	1,935	1,083

Source: Screen Digest

Figure 17: Overview - Margins and costs by window (100%=retail revenue)

	Consumer spending (retail revenue)	Retail costs/ margin	UK distributor revenues	Distribution costs/margins	Net studio revenues
Cinema	100	59	41	47	-6
DVD Retail	100	21	79	40	40
DVD Rental	100	83	17	3	14
TV VOD	100	36	64	15	50
Pay TV	100	53	47	0	47
Free TV	100	0	100	0	100
Grand Total	100	37	63	28	35

Source: Screen Digest

3 Cinema

3.1 Key findings

- **Market status:** The UK cinema market is mature, characterized by high density of multiplex screens and concentration among leading cinema providers. There were 3,569 screens at end 2006, of which 70 per cent were multiplex (at least five screens per cinema). By 2011, we project there will be a net increase of four per cent to 3,714.
- **Movie consumption levels:** average admissions per capita were 2.6 last year, and are struggling to break the three times average frequency. The most recent high for cinema admissions was in 2002, thereafter it has plateaued.
- **Business terms:** agreements between distributors and exhibitors, known as 'rentals', stipulate revenue sharing terms and are agreed on a strictly film by film basis. There are three different types of 'rental' agreements known as: 'sliding scale', 'house nut' and 'special terms'.
- **Movie window:** the theatrical window is regarded as a marketing platform and most distributors will not make profit at this stage.
- **Value chain:** the upfront costs of marketing a film must be expended before a film has even reached cinemas. Distributors are responsible for the print and advertising costs which amounted to £306.3m last year.
- **Consumer spending (exhibitors' revenue):** UK cinemagoers spent £648m (VAT net) in 2006 in 156.6m visits to the cinema, with an average ticket price of £4.78. By 2011, we expect box office movie revenue to grow to £842m, driven by small ticket price inflation, a stable market, with incremental rises in cinema attendance. Digital cinema is expected to provide a boost due to increased flexibility, as well as more and varied content.
- **Principal providers:** the market is concentrated with the top five cinema chains accounting for 80 per cent of box office and 70 per cent of cinema screens. Private equity firms hold large stakes in the UK exhibition sector. A plethora of corporate activity has occurred over last few years, including acquisitions, mergers and consolidation.
- **Distributor revenues:** we estimate that distributors receive around 41 per cent of net box office revenue, equivalent to £265m in 2006.

3.2 Market Overview, Exhibition and Distribution

55. In this section, we analyse the theatrical market, taking into account the film value chain from cinema exhibition to film distribution.

56. The exhibition market in the UK is relatively mature, a contention defined by the high concentration of cinema screens among the leading cinema chains, a slow down in overall screen growth and market consolidation. Moreover, cinema admissions appear to have stabilised in recent years, albeit with gradual rises in most years. In terms of market size, the UK theatrical market generated £762m in box office revenues in 2006, which was a slight drop of two per cent year on year. The UK market also remained fairly resilient to the widely reported admissions slump across continental Europe in 2005.

57. Admissions have been steadily but gradually increasing, reaching a high of 175.9m back in 2002 compared with 116.1m in 1995 (a 50 per cent increase), but more recently a plateauing has occurred. It has been speculated in the industry that possible explanations for this may include: piracy, a drop in the quality of films, changing consumption patterns, and to some extent competition from other entertainment options.

58. The modernisation of screen infrastructure did much to drive admissions during the 1990s. There were 3,569 screens in the UK at end 2006, housed in 783 sites. This gives a relatively high – in international terms – average of 4.6 screens per site. Screen growth has slowed down in the past few years, but there has been a net addition of over 400 new screens since 2001 (3,164 screens). This is partly due to concentration amongst exhibitors reducing the number of screens, which is offset by the building of newly sited complexes, which is increasing it.

59. Of these screens, some 70 per cent (that is 2,532) are defined as existing in a multiplex (a site with five screens or more). There are 252 multiplex sites, with an average of 10.0 screens per site. The main growth period occurred as a result of rapid multiplex construction during the 1990s.

60. There are 59.2 screens per million head of the population, a figure that has been steadily rising for at least a decade (35.0 per million in 1995). London accounts for 22.1 per cent of the country's screens, or 787 screens.

61. There has been a plethora of acquisition and merger activity in the UK exhibition industry recently, which has resulted in concentration down to three main players: Odeon, Cineworld and Vue Entertainment, of which Odeon and Cineworld are still controlled by venture capital firms.

62. Together they control over 59 per cent of the screen base. Meanwhile, the UK independent sector (those not part of a large cinema chain or investment group) accounted for 23.3 per cent of UK screens but just 10.1 per cent of box office revenues in 2005, nonetheless an increase of 5 per cent on 2004.

3.2.1 Cinema Exhibition

63. US Studios have practically severed all ownership links with the UK exhibition sector, a trend which has also been mirrored worldwide.

US Studios and history of ownership in UK exhibition sector

64. In the UK, the exhibition sector was extensive but highly fragmented until the mid 1920s. The formation of Gaumont British Picture Corporation in 1926 was an attempt at vertical integration. In 1929, Gaumont's takeover of Provincial Cinematograph Theatres gave it a chain of 287 screens. As early as 1938, Warner Bros established a showcase cinema in Leicester Square. The company subsequently acquired a 25 per cent stake in Associated British Picture Corporation (ABPC). In 1941, J Arthur Rank's General Cinema Finance Corporation (GCFC)—which had bought into the Odeon cinema chain in 1938—took over Gaumont-British Picture Corporation, giving the Rank Organisation a chain of over 600 cinemas and boosting its production capacity. These two chains, later known as the 'duopoly', then controlled 24 per cent of all UK screens (a proportion that rose to more than a third by 1944 and two thirds by 1966) and dominated exhibition for the next 50 years. Both were also involved in production.

65. By 1945, Warner's attempt to gain control of ABPC led to a 10-year agreement with the Board of Trade that it could benefit from its increased shareholding but not with voting rights. In theory, Warner would distribute ABPC films in their 800-screen US cinema chain, while ABPC would show Warner films in its UK cinemas. However, few British productions resulted from the tie-up and in 1961 Warner agreed with the Board of Trade to sell its shares.

65-1. EMI bought a stake in ABPC/ABC in 1968 by acquiring the remaining Warner Bros shares and launched a bid for full control. In 1970 MGM closed its studio at Elstree and in partnership with EMI formed EMI-MGM Elstree Studios at the former ABPC studios but MGM withdrew from the arrangement in 1973.

66. In 1983, the Monopolies and Mergers Commission (MMC) concluded that 'a scale monopoly' existed in respect of the film exhibition activities of EMI Cinemas and Rank Leisure (Odeon). 'A scale monopoly' also existed in the distribution sector in favour of Columbia-EMI-Warner and United International Pictures (UK) and that overall there was a 'complex monopoly' created by the combined activities of these distributors and exhibitors, and in particular the 'barring' arrangements which existed against the public interest. Barring reflects arrangements between the main exhibitors and basically prescribed the order in which cinemas in the same

locality could show a film, which in turn was accepted by the distributors. This system was maintained through exclusive agreements for several films at one time. This practice caused delays in other exhibitors gaining access to films and the MMC recommended that the practice should cease. Later EMI sold ABC to the Canon group, which was already a vertically integrated film company in the UK. Rank sold the Odeon cinema chain in 2000 and has now sold off all its film-related assets.

67. Later, the big Studio names re-emerged into UK exhibition. MGM Cinemas came onto the scene in 1990 but was soon embroiled in financial problems and scandals and was in receivership by 1991; the UK cinemas and the US Studios were sold off by the principal creditors, Crédit Lyonnais, in 1995 and 1996 respectively. Warner, present in the West End since 1938, began to expand exhibition interests, building a chain of 329 screens that were sold in 2003 to become Vue Cinemas.

68. Pan-European cinema operator UCI Cinemas emerged in the late 1980s controlled by a joint venture between Paramount and Vivendi Universal; in which Paramount was the majority partner with 51 per cent. It was later acquired by private equity firms Terra Firma Capital Partners, which also acquired the interests of UCI in Europe.

69. French media group Vivendi holds a 40 per cent stake in the French-based UGC cinema chain, which also has a pan-European

Figure 19: Outline of Studio brands and main parent company

Studio	Parent Company	Brands
Disney	Walt Disney Company	Disney, Miramax Films, Pixar, Touchstone Pictures, Hollywood Pictures
Sony	Sony Corporation	Sony Pictures, Columbia Pictures, Sony Pictures Classic, Screen Gems, TriStar Pictures, Sony Pictures Animation
Fox	News Corporation	Twentieth Century-Fox, Fox Searchlight Pictures, Blue Sky Studios
Warner	Time Warner	Warner Brothers, New Line, Warner Independent Pictures, Castle Rock, Picturehouse (Joint with HBO)
Universal	NBC Universal (General Electric 80%, Vivendi 20%)	Universal Pictures, Focus Features, Rogue Pictures, Working Title Films
Paramount	Viacom	Paramount, Dreamworks SKG
Dreamworks Animation	Public	Dreamworks Animation
MGM	Independent consortium led by Sony (20%) Comcast and private equity firms	United artists, Samuel Goldwyn Films, Orion Pictures (defunct), American International Pictures (defunct)

Source: Screen Digest

presence. However, the UK assets were sold to US investment firm Blackstone in 2004, and then later merged to create Cineworld. UGC still has assets across Europe.

70. The only current link between US Studios in UK exhibition is Showcase Cinemas and its parent company National Amusements, which in turn owns 11 per cent of Viacom (the parent company of Paramount, Dreamworks SKG). National Amusements owns over 1,500 screens worldwide.

Industry Regulation and Film Orders

71. In 1983, the MMC (now the Competition Commission) published a report 'A Report on the Supply of Films for Exhibition in Cinemas, May 1983' (MMC- Cmnd 2673) which found that arrangements existed between the main exhibitors and distributors, prescribing the order in which cinemas in the locality could show a film, a system termed 'barring'. The system was based on exclusive agreements that were made for several films at the same time, rather than on an individual film basis, and is linked to practices of 'alignment'. Alignment is when particular distributors would always offer their films first to their preferred exhibitor. Different distributors would also have different preferred exhibitors and therefore the market would be to some extent aligned together.

72. In 1989, an order was introduced - 'The Films (Exclusivity Agreements) Order 1989' (SI 1989 No. 271), which made it unlawful for an exhibitor or distributor to make or carry out any agreement to the supply of any film for exhibition at a cinema if the agreement contains or includes terms in their supply agreements for more than one film, and for

exhibitors not to preclude any film on the basis that other films by the same distributor had not yet been agreed upon for theatrical release.

73. In 1996 an additional order 'The Films (Exhibition Periods) Order 1996' (SI 1996 No 3410)- was introduced to prevent distributors imposing minimum lengthy exhibition periods. As a result, a maximum screening requirement of two weeks was introduced for first run releases. This order was aimed at a) helping exhibitors respond better to customer demand b) to free up some screen space for independent distributors and c) protect smaller exhibitors.

74. A report by the OFT in 2004 ('Review of Orders Following 1983 and 1994 MMC Monopoly Reports on the Supply of Films for Exhibition in Cinemas, 26 July 2004') found that the system of 'barring' does not operate today, although they note that the considerable change in cinema infrastructure including the proliferation of screens and greater competition between main exhibitors, would make the industry unlikely to return to this system. The same report concluded that all six major distributors were supplying films to all six main exhibitors. However, one notable exception was the West End of London, where certain exclusivity still takes place. For example, one distributor is likely to favour a particular cinema/s for screenings. It is worth noting that the West End market is different in that it hosts premieres and other film publicity events, whereas different cinema sites may appeal to different genres of film.

Figure 20: Cinema - History of Studio ownership in UK exhibition

Cinema	Ownership	Sold to
MGM Cinemas	MGM/Pathe: 1990-1993	Virgin Cinemas in 1993
Warner Village	JV Warner International Cinemas/Village Roadshow: 1993-2003	SBC (Vue Entertainment) in 2003
UCI Cinemas UK	JV Universal/Paramount, Vivendi:1986-2004	Terra Firma in 2004
UGC Cinemas	40% Vivendi:1999-2004	Blackstone:2004
Showcase Cinemas	National Amusements (owner also has stake in Viacom): since 1988	N/A

Source: Screen Digest

3.2.2 Theatrical Distribution in the UK

75. There were 68 active theatrical distributors in the UK in 2006, up from 61 in 2004 and 53 in 2000. Of the total box office, £265.8m in net revenue ended up with distributors, equivalent to 35 per cent of gross consumer spending. This produces an average net revenue per distributor of £3.9m, although it is clear that a handful of distributors dominate the revenues.

76. There was an average of 7.4 films released per distributor, down from 8.4 in 2003. UIP, a joint venture set up by Universal and Paramount for theatrical distribution in international markets, and also distributes for Dreamworks SKG (owned by Paramount), accounted for the highest number of film releases at 44.

In 2006, Twentieth Century-Fox was the most successful distributor in the UK, with a market share of 21.0 per cent, followed by UIP with 18.6 per cent.

77. In total, there are six US majors with direct distribution operations in the UK namely Disney, Sony Pictures, Twentieth Century-Fox, Warner Bros, Universal Pictures and Paramount Pictures. The UK subsidiary operations of the US Studios accounted for a combined 79.6 per cent of the UK box office. The joint venture partnership between Universal and Paramount (UIP) for theatrical distribution came to an end in the UK and several other territories in late 2006. Paramount and Universal now operate separate distribution in 15 countries, including the UK, while the joint venture UIP still operates in 20 international territories, compared with 35 previously. The decision follows on from a long-running partnership which was set up back in 1981, originally incorporating MGM and United Artists Corporation (UA). However, the latter two exited in 2000, which also led to speculation of a forthcoming split. The arrangement allows the Studios to control distribution more closely in their respective territories and is also a response to the growing international market place for distribution of US films.

78. In 2006, the leading UK distributor was Entertainment Film Distributors, with a relatively poor 8.0 per cent box office market share. The company has outperformed this in the past five years, notably with 16.8 per cent

in 2002 and 14.6 per cent in 2003. This was largely due to holding the UK rights to the *Lord of the Rings* trilogy.

Theatrical Releases

79. There were a total of 505 first run theatrical releases in 2006, representing an additional 151 films compared with the corresponding total in 2001 (354). Previously, the number hovered around the 350 mark, indicating this trend has substantially risen in the last six years. The number of film releases of US origin has also been increasing although still accounting for a similar proportion of the total market; typically US films account for around 35 per cent of releases and up to 80 per cent of box office revenues. In 2005, there were 189 films from the US (including co-productions) compared with 115 in 2001.

Business model of UK theatrical distributors

80. The theatrical distributor has two main activities: acquiring films (or the rights to distribute them) and marketing films. The distributor is required to take a risk to stay in business. The upfront costs of marketing a film must be expended before a film has even hit the cinemas. The upside is their share of the potential box office revenue earned by a title. The risk can vary depending on several factors, which will all be reflected in the negotiations with an exhibitor. Often, a US Studio movie will have received a first theatrical airing in the USA, which will provide a box office track record for that movie that may lessen the risk taken by the UK distributor. Conversely, a poor US performance and the knock-on bad publicity, reviews and word-of-mouth, can make it very difficult to successfully market the film in the UK.

Terms of business between cinema exhibitors and theatrical distributors

81. Distributors have regular meetings with cinema exhibitors, presenting their upcoming product 'slates' (including screenings) and marketing campaigns to the exhibitor in an attempt to secure a release contract for their titles. For each film, a distributor negotiates a confidential licence agreement bilaterally with each exhibitor interested in screening the film.

82. The maximum booking period for a new release is two weeks, after which the distributor and exhibitor can agree to prolong the release if appropriate. More and more, the key period in a film's ultimate gross is the opening weekend. The marketing campaign builds to that weekend, and the first week often accounts for between a third and a half of a title's total gross.

83. Obviously, the licence agreement is the heart of a distributor's business and profitability. Revenue from ticket sales is generally shared between the distributor and exhibitor, after the exhibitor's costs of operating the screen are recovered and VAT is deducted. The percentage each party takes may vary week-by-week and film-by-film. The net share that the distributor ends up with is traditionally known as the distributor's 'rentals', which are on average around 40 per cent in the UK. The distributor usually receives a higher proportion of the initial release period, with a decreasing scale kicking

in for any prolongations. The type of rental agreement will depend on factors such as the track record of the film in a previous release, competing titles in the market, period of the year, even the weather.

84. There are three main types of 'rental' negotiations known as 'sliding scale', 'house nut' or the increasingly used 'special terms'.

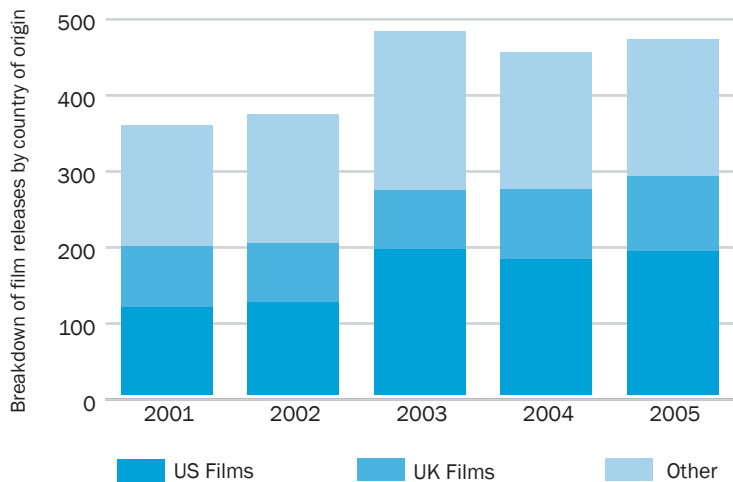
85. The 'sliding scale' is based on revenue accrued at the box office, whereby the higher level of revenue, the more the distributor receives. This may be as a set fee or more likely, a pre-agreed split in the first two weeks, with any extension to the contract being negotiated on a sliding scale after this time.

86-1. The 'house nut' method is more traditional and allows the exhibitor to recoup all the operating costs before passing on the distributor's share of the revenue. This method is usually based on a per seat basis, and thereafter the split of the surplus is usually in favour of the distributor even 90/10.

86-2. More recently 'special terms' have become increasingly widespread in the industry and are based on a fixed percentage of film rentals, which tend to be at a higher rate than usual in favour of the distributor. It is also worth pointing out that UK distributor rentals are amongst the lowest in Europe, although the recent trend is upwards (i.e. in the distributor's favour). Distributors respond to this by re-iterating the low rentals level in UK, and the high cost of advertising, in addition to the costs associated with producing digital 'prints'.

86-3. The move towards 'day-and-date' release (i.e. when a film is released globally on the

Figure 22: Cinema - Number of Film releases (2001-2005)



Source: Screen Digest from Nielsen EDI data

Figure 21: Cinema - Number of Film releases (2001-2005)

	2001	2002	2003	2004	2005	2006
USA	115	122	192	178	189	na
UK	81	77	77	93	99	na
Others	158	170	209	179	179	na
Total	354	369	478	450	467	505

na: not available

Source: Nielsen EDI, UK Film Distributors association

same day and date) increases the risk for both parties, as there will be no track record to study. It is very difficult to predict how a distributor will fare with a particular title and even more so over a year, with each title released being a risk and capable of being a runaway success or a complete 'turkey'.

87. The weekend is consistently the most important time for cinema exhibitors. In 2006, the weekend (Friday, Saturday and Sunday) accounted for over 60 per cent of a given week's cinema admissions'.

UK film releases by number of prints

88. There has been a sharp decrease in the length of time films stay on at cinemas. In 1994, 28 of the top 50 movies played at the cinema for more than 13 weeks, but ten years later that number had reduced to just nine, indicating a trend towards higher burn rates. This is also evident by the fact that the top 50 films accounted for an average 45 per cent of their revenue in the first week of release in 2005, compared with 22.8 per cent in 1994. The freeing up of screens in this way is one of the reasons that there are more film releases in the market, and this also leads back to higher domestic and global film production levels.

Prints & Advertising costs

89. The UK is one of the few territories where some data on Prints & Advertising (P&A) costs incurred by film distributors is available. According to data from the UK film distributors association, theatrical distributors in the UK spent a record £306.3m releasing feature films in 2006, which is 4.6 per cent higher than 2005, and again 8.0 per cent higher than in 2004. This does not include costs incurred for premieres and related publicity, which is estimated at £6.75m in 2006.

90. The breakdown of P&A costs reveals that £135m was spent on prints and trailers (44.1 per cent of the total), while advertising spend accounted for the majority (£171.3m) in 2006. Of these two costs, the basic costs for prints and trailers rose by a greater 6.6 per cent year on year. Television continued to account for the largest share (42.6 per cent) of advertising expenditure by media, while outdoor advertising also increased to £60.0m, a 20 per cent increase on 2004.

91. Overall, average P & A spend per movie dropped to £606,500 in 2006, from a total of 505 film releases, from an average £650,200 in 2005. However, it is clear that many films have much less spent on them, while a smaller number will account for the majority of ad spend. The US Studio releases make up the largest proportion of the higher-spend category.

92. One print costs around £1,000-£1,500 to produce. A widely released film may open on around 1,500 screens, requiring an initial layout of at least £1.4m on P&A before the film is even seen by an audience. There are also the marketing costs of a wide-release film, which can be several million pounds for a US Studio release.

93. In the UK, the majority of films are released on less than 200 prints. A small minority are released onto 1,000+ screens (event movies). A small 'art house' title (maybe foreign language) may be released on fewer than 10 prints.

Film Prints: Transportation

94. The distributor will contract out the making and shipping of prints to a third party. The largest of these are Technicolor and Deluxe FilmLabs. These companies will be tasked with producing prints, but new copies may be required a few weeks into the film's release if a title is successful and distribution is expanded onto new screens. Prints should be shipped from the film lab to the print management service via a form of approved transport. Most distributors will store the copies of 35mm prints at central warehouses from which films are transported via standard delivery services or couriers, physically transporting them, usually by road. FACT (the Federation against Copyright Theft in the UK) publishes a list of authorised agents, and recommends that all UK transport contractors and sub-contractors are FACT-accredited. Some prints that enter the UK from an overseas lab will travel by land or air cargo. According to FACT, around one in ten prints are delivered by local carriers or agents, and these are usually contracted by smaller cinema chains or independent cinemas for convenience or economy. These transport operators typically only operate in local regions and have more infrequent services. It is also worth noting that sometimes London West End Cinemas will occasionally receive

prints direct from the film distributor. The logistical service operators have no strategic value in the movie chain.

95. The distributor's rights to the film expire on destruction of the film. A few copies are kept back for archive purposes. With digital cinema it is possible for exhibitors themselves to retain archive and classic films for screening, digitally, although an electronic key code will be required to access the content, and is usually set for specific dates relative to screenings.

Piracy

96. The spectre of piracy necessitates the practice of strict procedures at every stage of the film print life cycle, including processing, transport, storage and usage. Piracy is a key driver behind the switch to digital cinema, offering more ways to combat illegal film theft, which is of particular interest to the major Hollywood Studios which lose an estimated \$3bn a year in copyright theft. New systems allow content providers to embody a digital watermark in a digital print that tracks the precise day, time and place a video copy was made. It also offers a method for secure distribution whereby each digital film copy

is compressed and then encrypted before transportation. The individual cinema will then be required to enter an individual security key in order to be able to access and decrypt the file. The delivery of electronic keys to cinema occurs independently from the digital copy. Another main attraction of a digital cinema network is that it will eliminate the costs of physically creating and transporting prints to a cinema. For further details on digital cinema and its potential impact on the film value chain please refer to the Looking Forward section Chapter 3.6.

3.3 Market data

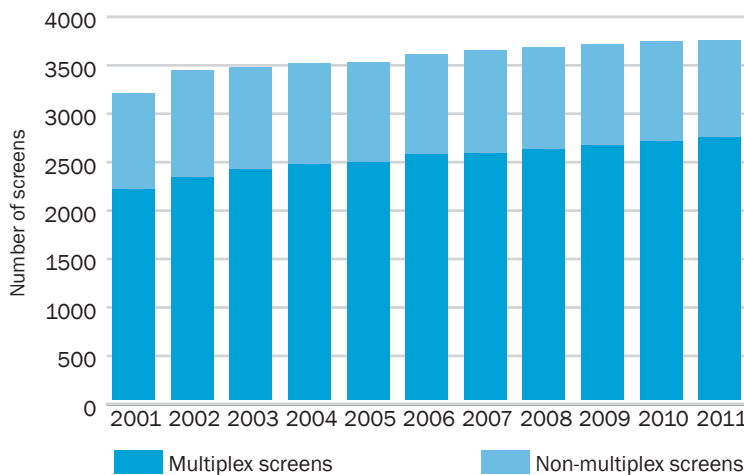
Market Revenues

97. The UK box office was worth £762.1m in 2006, representing a slight 1.8 per cent fall compared with the same total in 2005. Total box office has increased over 18 per cent in absolute terms since 2001. Screen Digest forecasts gross box office revenue will hit £989.3m in 2011, a 29.8 per cent increase over the next five years. The increase will be driven by ticket price inflation and a very slight rise in annual admissions per head.

98. Box office revenue represents approximately 65 per cent of total exhibitor revenue with concessions, screen advertising and ancillary revenues including alternative content providing the remainder. Cinema exhibition was worth a total of £1.16bn in 2006, taking all revenue streams into account. These revenue streams account for very different proportions of income and profits in different cinema circuits (and even individual cinemas within a circuit). The box office was derived from a total of 156.6m cinema ticket sales with an average ticket price of £4.87 in 2006.

99. Cinema admissions reached a recent peak of 176m in 2002, and recorded almost 20m fewer admissions in 2006 than this benchmark

Figure 24: Cinema - Exhibition Infrastructure (2001-2011)



Source: Screen Digest from Carlton Screen

Figure 23: Cinema - Exhibition Infrastructure (2001-2011)

No of screens	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
screens	3,164	3,402	3,433	3,475	3,486	3,569	3,612	3,641	3,670	3,696	3,714
multiplex screens	2,170	2,295	2,378	2,430	2,449	2,532	2,540	2,583	2,627	2,670	2,714
% multiplex screens	68.6	67.5	69.3	69.9	70.3	70.9	70.3	70.9	71.6	72.3	73.1

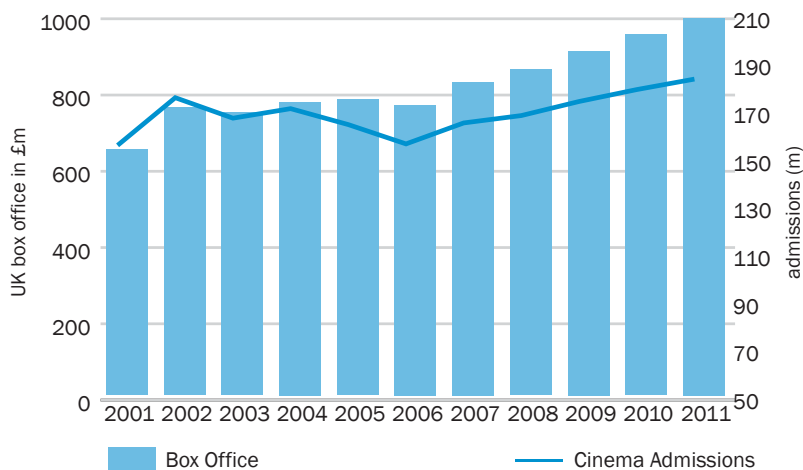
Source: Screen Digest from Carlton Screen

year. The cinema market is regarded as cyclical, where the quality of movie product can result in annual fluctuations. One important factor in driving box office revenues is home-grown films. This was a key driver behind the UK recording stable box office revenue in the UK in 2005, amid a worldwide slump. During that year, UK films accounted for 33 per cent market share, against a normal average of 23 per cent. More generally, annual admissions per capita have struggled to break the three times frequency in the UK.

3.4 Flow of Funds

100. Consumer spending recorded £762.1m at the box office in 2006 (equivalent to £648m in net revenues after VAT is deducted). The principal exhibition providers (Odeon, Vue Entertainment, Cineworld, Showcase and Empire Cinemas) retained £305.3m in revenues, after providing £212.1m in film rental payments to distributors. Overall, applying revenue sharing assumptions, distributors received approximately 35 per cent of the gross box office total.

Figure 26: Cinema - Admissions and box office revenue (2001-2011)



Source: Screen Digest from Nielsen EDI, Carlton Screen data

Figure 25: Cinema - Admissions and box office revenue (2001-2011)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
adms in m	155.9	175.9	167.3	171.3	164.6	156.5	165.3	168.4	174.3	179.3	183.7
adms/capita	2.64	2.97	2.81	2.86	2.74	2.60	2.73	2.77	2.86	2.93	2.99
adms/screen	49,276	51,705	48,720	49,290	47,235	43,865	45,770	46,246	47,516	48,501	49,463
gross box office (£m)	645	755	742	769.6	776.3	762.1	821.6	854.4	902.6	946.3	989.3
net box office (£m)	548.9	642.6	631.5	655	660.7	648.6	699.2	727.1	768.2	805.4	842

Source: Screen Digest from Carlton Screen

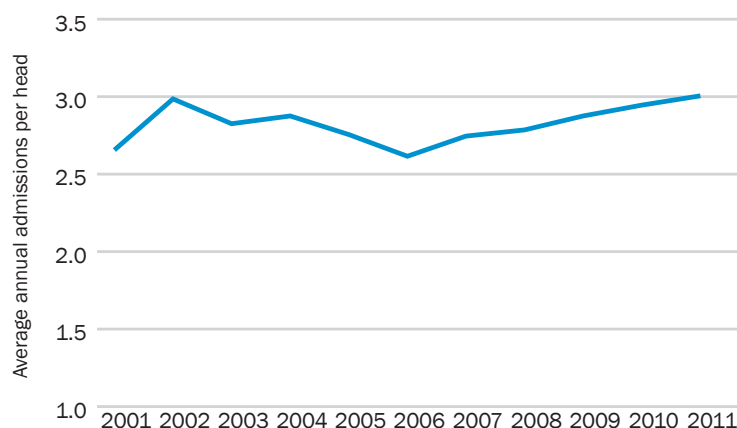
101. The UK direct subsidiary operations of the US Studios control 80 per cent of distributor level revenue, taking a combined £211.6m, leaving just £54.2m to local and independent distributors.

102. The distribution sector as a whole made a net loss of £41.6m in 2006, although this is compounded by an additional sum of £6.75m spent on premieres and publicity, which is not included in the prints and advertising (P&A) expenditure. The UK direct subsidiary operations of the US Studios made a combined net loss of £0.36m, after P&A costs were expended.

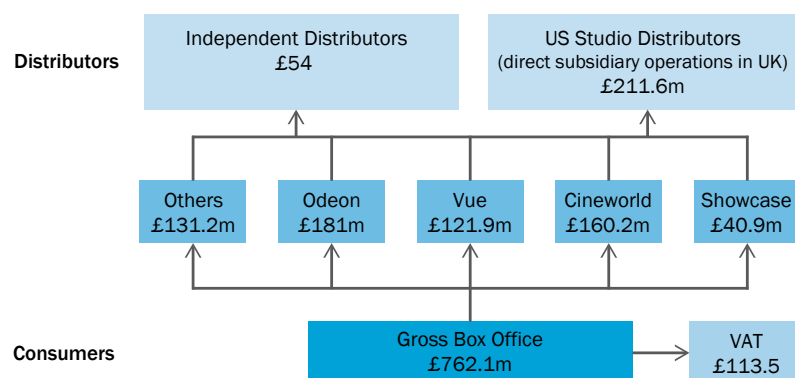
103. According to the UK Film Distributors Association (FDA), there were an estimated 120,000 prints in the UK market in 2006. According to Screen Digest, US Studios accounted for around 76 per cent of all film prints in circulation.

104. Of the total expenditure on prints and advertising (£306.3m), Screen Digest estimates that UK direct subsidiary operations of the US Studios spent a total of £212.0m, equivalent to 70 per cent of total industry 'P&A' spend. The US majors will receive bulk discounts on print costs because of wider releases. The print costs of a niche release or foreign language print including subtitling can cost up to £4,000 in the UK, nearly four times as much as a basic print.

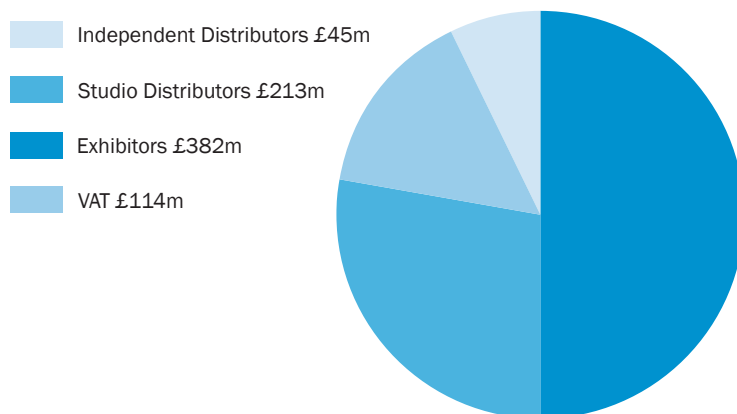
105. The average advertising costs of a US Studio title will be much higher than an independent release. On average the US majors spent an average of £1.4m per release on prints, trailers and advertising compared with an average £0.7m for independents such as Entertainment or Lionsgate UK. Most distributors do not make a profit at the theatrical stage. The theatrical platform is

Figure 27: Cinema - Buy rate

Source: Screen Digest

Figure 28: Cinema - Total Market Flow of Funds (before P&A costs) 2006

Source: Screen Digest, including analysis of Niesen EDI data

Figure 29: Cinema - Net shares of total Box Office 2006

Source: Screen Digest

viewed as a marketing tool to recoup further revenues downstream in subsequent windows. This is mostly due to the high costs of 35mm prints.

Buena Vista International (UK) Limited

106. Buena Vista (BV) had a market share of 15.6 per cent in 2006, which translated into distributor revenues of £41.5m. With 25 releases, P&A costs are estimated at £36.2m, which gives a net profit of £4.7m. In the UK, BV distributed product from Disney, Miramax and Weinstein.

Sony Pictures Releasing

107. Sony Pictures Releasing (Sony) took a 16.3 per cent market share in 2006, with distributor level revenues of £43.3m. With 30 releases, P&A costs were £39.9m, resulting in a net profit of £3.1m. In the UK, Sony distributes product from Sony Pictures Entertainment, Sony Pictures Classic, and Screen Gems.

Twentieth Century-Fox

108. With the leading 21.0 per cent market share (distributor level revenues of £55.8m) and 30 releases, Twentieth Century-Fox (Fox) incurred an estimated £49.3m in 2006. This resulted in a small net profit of £12.1 m. In the UK, Fox distributes product for Fox Film and Fox Searchlight.

Warner Bros.

109. Warner Bros took an 8.1 per cent market share in 2004. With 21 releases, the company incurred an estimated £29.6m in P&A costs, giving a net distributor loss of £8.0m. Warner distributes mostly product from Warner Brothers and Warner Independent.

UIP

110. UIP was a joint venture between Paramount and Universal, which also distributed Dreamworks SKG and Dreamworks Animation product in the UK. The company took a combined 14.8 per cent market share (distributor-level revenues of £39.3m in 2006). With 38 releases, estimated P&A costs incurred were £51.2m. This resulted in a net loss of £11.9m, according to Screen Digest.

111. Following the dissolution of the UIP joint venture in the UK market at end 2006, there were four films that were subsequently distributed by Paramount Pictures UK, including one Dreamwork's animation title and another two films that were distributed by Universal Pictures UK. In 2006, UIP released titles from Universal, Paramount, Focus Features, Rogue Pictures and several acquisitions (MGM, Dimension Films, New Market)

Universal Pictures UK

111-1. At end 2006, Universal Pictures UK (Universal) released two titles independently of its former joint venture distribution arrangement (UIP). Universal accounted for a small 1.9 per cent market share or £5.05m in distributor net revenues. After £3.67m of P&A costs were expended, the result was a small net profit of £1.3m.

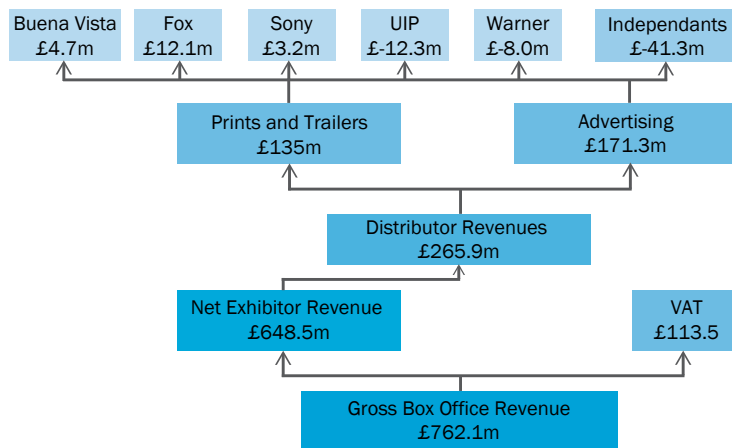
Paramount Pictures UK

111-2. In 2006, Paramount Pictures UK (Paramount) released four titles independently of its former joint venture (UIP), including one Dreamworks Animation title. In October 2006, Paramount Pictures UK agreed an eight film distribution deal with The Weinstein Company (TWC). Paramount accounted for a 1.9 per cent market share from four theatrical releases, equivalent to £5.05m in distributor level revenue. Estimated P&A costs were £6.8m, resulting in a net loss of £1.74m.

Entertainment Film Distributors

112. Entertainment Film Distributors (Entertainment) is a UK production and distribution company, specialising in local independent films and distribution of titles for smaller US Studios. In 2006, Entertainment released 20 titles from distributor revenue of £21.2m (8.0 per cent market share). It finished with a small net profit of £0.03m, once estimated P & A costs of £21.2m were expended. In 2006, Entertainment distributed

Figure 30: Cinema - Theatrical movie cash flow, including P&A costs 2006



Source: Screen Digest, including data from UK Film Distributors Association

Figure 31: Cinema - Principal UK theatrical distributors

Studio	UK distribution subsidiary	Affiliated studio brands distributed	Affiliated studio brands not distributed	Independant brands distributed	Notes
Disney	Buena Vista International (uk) Limited	Disney, Miramax Films, Pixar, Touchstone Pictures, Hollywood Pictures			
Sony	Sony Releasing UK	Sony Pictures, Columbia Pictures, Sony Pictures Classic, Screen Gems, Tristar Pictures, Sony Pictures Animation			*distributes the James Bond franchise in the UK (from MGM)
Fox	Twentieth Century Fox UK	Fox, Fox Searchlight, Blue Sky Studios			
Time Warner	Warner Bros. UK	Warner Brothers, Warner Independent Pictures, Castle Rock, Picturehouse (joint with HBO)	New Line		
Universal	Universal Pitures UK	Universal, Focus Features, Rogue Pictures, Working Title			
Paramount	Paramount Pictures UK	Paramount, Dreamworks, SKG		Dreamworks Animation, The Weinstein company (TWC)*	*note: eight film deal only

Source: Screen Digest

features from New Line Cinema, and MGM. Its most popular title last year was *The Departed*.

Distributor agreement with producer/ rights holder

113. Out of the net share that the distributor ends up with, it usually recoups any minimum guarantee paid (see pre-sale) plus the P&A costs incurred in releasing the film. Any outstanding balance is termed Producers' Net Receipts and is shared with the producers (and other rights holders) according to a pre-agreed recoupment schedule. This is set out in the distribution contract, but of course does not generally apply to the UK subsidiaries of the main US Studios that effectively receive their UK theatrical distribution rights free of charge.

114. Alternatively, the distributor may also take a set distribution fee, with all net proceeds being paid to the producer. This may happen with a particularly risky title, in order to minimise the exposure of the distributor.

3.5 Principal theatrical exhibitors

114-1. Odeon is the leading cinema chain in the UK accounting for 24.2 per cent of the UK screen base. Showcase cinemas, the fourth largest exhibitor by screen provision, has the highest concentration of multiplex sites, given that its average screens per site is 12.8 compared with the UK average of 4.6 screens per site.

115. Together the principal theatrical exhibitors (Odeon, Vue, Cineworld, Showcase and Empire) accounted for 68 per cent of gross consumer spending (£762.1m) or 79.7 per cent of exhibitor net revenues (£648.0m) in 2006.

Figure 32: Cinema - Leading exhibition chains in the UK

Circuit	Sites	Screens	Seats	Screen S/Site	Seats/Screen	% Screens
Odeon	111	863	197,938	7.8	229.4	24.2
Cineworld	70	728	133,798	10.2	183.8	20.4
Vue	57	548	126,871	9.6	231.5	15.4
Showcase Cinemas	19	244	60,986	12.8	249.9	6.8
Empire	17	142	32,051	8.4	225.7	4
Apollo Cinemas	12	63	12,231	5.3	194.1	1.8
Picturehouse Cinemas	18	48	7,974	2.7	166.1	1.3

Source: Screen Digest

Figure 33: Cinema - Principal Theatrical Retailers (Exhibitors) 2006

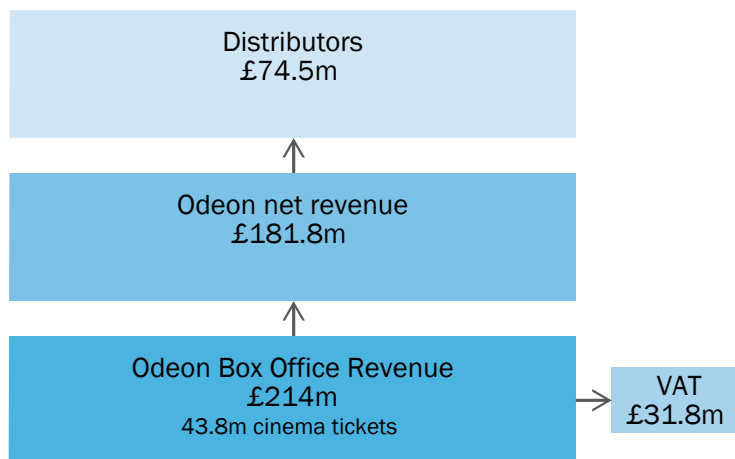
Circuit	Ownership	Screens	Screens %	Net Retailer (Exhibitor) Revenue £m	Market Shares % by revenues
Odeon (UCI)	Terra Firma Capital Partners (UK)	863	24.2	181.6	28
Cineworld	Blackstone (USA)	728	20.4	160.2	24.7
Vue Entertainment	Management BO	548	15.4	121.9	18.8
Showcase Cinemas	National Amusements (USA)	244	6.8	40.9	6.3
Empire Cinemas	Cinema Holdings (Ireland)	142	4.0	12.6	1.9
Top five circuits		2,525	70.2	517.4	79.7
Total		3,569	100.0	648.6	100

Source: Screen Digest, including Nielsen EDI data

Figure 35: History of Odeon and UCI Cinemas

History of Odeon Cinemas	
1930	Odeon Theatres began, established as private company in 1937
1941	Rank acquires control of Odeon and Gaumont British Picture Company
1955	Changes name to Rank Organisation
2000	Rank Group sold Odeon to Cinven, a Venture Capital firm
2000	Merged with ABC Cinemas
2003	Sold by Cinven to German bank West LB and partners
2004	Acquired by Terra Firma from auction
2005	Merger of Odeon and UCI cinema circuits by Terra Firma
History of UCI Cinemas	
1985	AMC opens first multiplex cinema in UK
1988	UCI acquires assets of American Multiplex Cinemas (AMC)
2004	Acquired by Terra Firma and later merged with Odeon

Source: Screen Digest

Figure 36: Flow of funds - Odeon

Source: Screen Digest

Figure 34: Cinema - Principal Providers net revenues (before 'rentals')

£m	2001	2002	2003	2004	2005	2006
Odeon (UCI)			132	150.6	170.2	181.8
UCI			80.8	78.6	36.8	0
Vue		90	95.4	99.6	112.8	121.9
UGC Cinemas			84	87.1	42.5	0
Cineworld			53.7	59.6	121.6	160.2
Showcase cinemas			42.9	44.5	42.5	40.9
Empire cinemas			0	0	0	12.6
Top Five			488.8	520.1	526.4	517.4
Total Market	549	642.5	631.4	654.9	660.6	648.6

Source: Screen Digest analysis of Nielsen EDI data

116. Together, the top three cinema exhibitors (Odeon, Vue and Cineworld) account for 59 per cent of the screenbase, and 71.5 per cent of net exhibitor revenues.

117. The five principal providers retained a total of £305.3m, after submitting £212.4m in film hire or 'rentals' to distributors.

Odeon

118. Odeon is the leading cinema circuit in the UK. In 2004, UK private equity firm Terra Firma Capital Partners (Terra Firma) acquired both the Odeon and UCI circuits. In one go, the company acquired two of the leading circuits for a reported sum of £582m, equating to around 28 per cent of the box office. The parent company of Odeon, Terra Firma, is a UK private equity firm that was established in 2002. Its strategic focus centres on acquisitions of large, complex businesses that require operational change. The company attempts to create additional value from these investments. Some recent acquisitions include Odeon/UCI, motorway service operator Tank & Rast and Waste Recycling Group. Terra Firma has also made several strategic acquisitions in the European cinema sector. Since its initial acquisition of UCI Cinemas Europe, it has embarked on further acquisitions in cinema exhibition leading to further consolidation, particularly in Spain. It now controls a total of 1,673 screens in seven different European territories.

119. The acquisition of both Odeon and UCI by Terra Firma of was given regulatory clearance by the OFT (OFT Press Release 81/05 9 May 2005) on condition that in 11 local areas across the UK, including the prime Leicester Square complex and two more in the

wider London area, sites would be divested where they met with competition concerns.

120. In 2006, Odeon established a joint venture with digital TV platform BSkyB for distribution of films in the UK—theatrical, DVD and television. DVDs will be available in Odeon foyers. Odeon and Sky Filmworks aim to sign up to six films a year directly from producers. The venture will release theatrically in Odeon and other cinemas. Sky will retain rights for TV exploitation and download on Sky Movies by Broadband and Sky Box Office.

121. Odeon also operates a strategic partnership with LoveFilm for DVD online rentals, termed 'Odeondirect'.

122. In 2007, Odeon became the first cinema chain in the UK to embark on a test of digital cinema equipment independently of the UK Film Council's (UKFC) Digital Screen Network (DSN) project. It has proceeded to equip two complete multiplex cinemas with equipment from various manufacturers in

order to test different technical parameters and appropriate business models, although it is currently trialling the VPF (virtual print fee) model in at least one site.

123. Odeon has portfolio of 863 screens housed in 111 sites, equivalent to 7.8 screens per site. Odeon retained an estimated £107.3m of movie revenues, after providing distributors with payments of £74.5m in 2006.

Cineworld

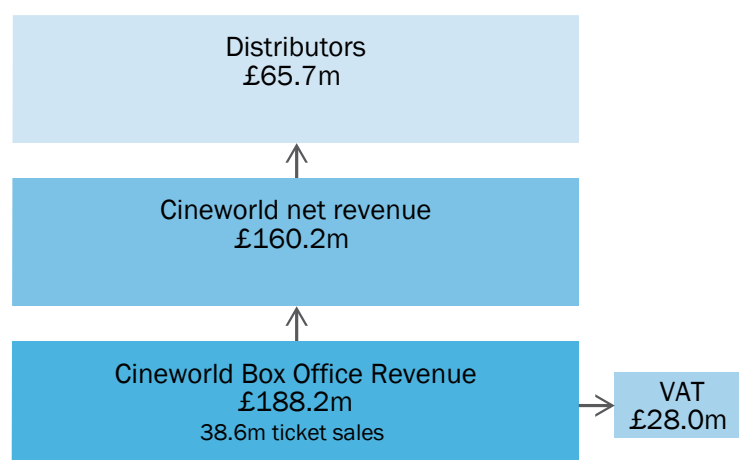
124. In late 2004, US investment firm Blackstone acquired Cine-UK and its 384 screens, for £120m and subsequently acquired UGC's 408 screens for £200m. Cine-UK was put up for sale in 2002 by its previous owners, JP Morgan Partners and Warburg Pincus. The new circuit was rebranded as Cineworld.

125. The Parent company of Cineworld is US investment firm Blackstone. It has various operations spread across private equity, real estate and corporate debt activities. It offers corporate advisory and restructuring advisory services. Blackstone is one of the largest private equity groups worldwide investing in over 100 companies across various industry sectors. Its portfolio includes firms such as Deutsche Telekom, United Biscuits, and Centre Parks; several of these investments were conducted in partnership with leading corporations such as Time Warner, Vivendi Universal and Sony.

126. In May 2007, Cineworld relaunched its initial public offering (IPO) a year after it first signalled the intention to become a public company. Cineworld sold around 43.3 per cent of its shares, valued at around £120m, for a total market capitalisation of £241m, the proceeds of which were used to pay off its debt. The management has retained 3.2 per cent of shares, leaving Blackstone with the majority 53.3 per cent. Cineworld first announced it would list on the stock exchange in May 2006 but pulled out after adverse market conditions affected the price of European shares. Another attempt was also shelved in September 2006.

127. The acquisition by Blackstone of both Cine-UK and UGC was not referred to the Competition Commission by the OFT on the grounds that it would divest sites in six key areas in order to meet competition concerns (OFT Press Release 112/05, 21 June 2005).

Figure 38: Flow of funds - Cineworld



Source: Screen Digest

Figure 37: History of Cineworld

1986	EMI Cinemas acquired by Canon Group
1990	Canon Group acquires MGM
1993	Operates separately from MGM, reports to Credit Lyonnais
1995	MGM cinemas acquired by Virgin
1999	Virgin sells cinemas to UGC
2004	UGC Cinemas sold to Blackstone a US venture capitalist
2004	Blackstone acquires Cine-UK and UGC Cinemas
2005	Merger to create Cineworld

Source: Screen Digest

128. Cineworld operates 714 screens housed in 70 sites. It has three cinemas with 16 screens, the largest sites in its exhibition portfolio. In 2006, Cineworld retained £94.5m in movie related revenues, after paying distributors £65.7m.

Vue Entertainment

129. Vue Entertainment is the third largest cinema chain in the UK, comprising 548 screens at end 2006. It was first created from the merger of Warner Village Cinemas with UK start up company SBC. In 2006, its management secured a buy out (MBO) in partnership with Bank of Scotland for around £350m (\$643m) and has seen the ownership of share holdings transferred from the previous consortium of investors led by Boston Ventures, Clarity Partners and Legal & General to the current management, who now controls the majority 51 per cent stake and its major investor (Bank of Scotland Integrated Finance) a minority stake. In May 2005, Vue also acquired the assets of Ster Century Cinemas (Ster), the South African cinema group which has since divested all its international investments. The assets of

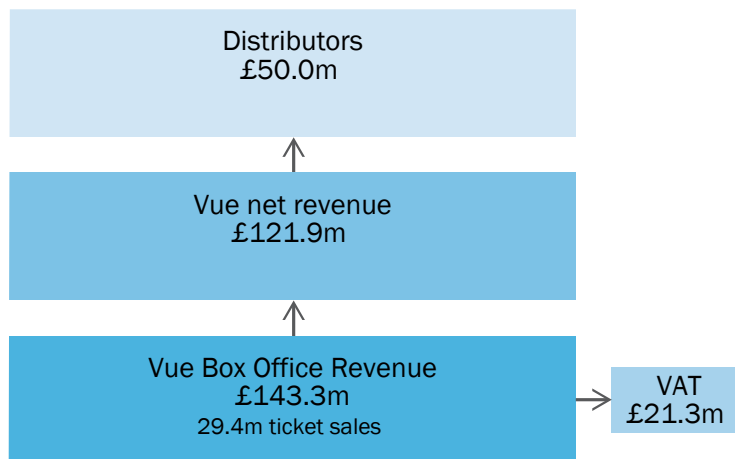
Ster were previously owned by two different investment consortiums before they were sold to Vue. In July 2003, Ster was acquired by a management buy out team backed by Inflexion Private Equity. In July 2004, the company was refinanced, backed by investment group Hutton Collins, which resulted in the creation of A3 as the parent company of Ster. Vue acquired all the share capital of A3, of which Ster Century, is an indirect subsidiary. Separately, Vue also announced it would acquire the remaining five cinema sites of Village Roadshow in the UK. The management team at Vue is headed by Tim Richards and Steve Knibbs.

130. Vue's most recent cinema acquisition of A3 Cinema and its subsidiary Ster Century (UK) was referred by the OFT (OFT Press Release 176/05 23 September 2005) to the Competition Commission on the grounds that it may lead to a substantial lessening of competition to the detriment of cinemagoers in three key areas: Basingstoke, Romford and Leeds. The Competition Commission filed a completed report on the acquisition of A3 Holding by Vue Entertainment on 24.02.2006. The main outcome was that the acquisition would substantially lessen competition and create a near monopoly situation in the area of Basingstoke. As a result, the 10 screen Basingstoke Leisure Park multiplex has now been acquired by Odeon, while Vue still operates the Basingstoke Festival Plaza.

131. In 2005, Vue agreed a marketing partnership with Screen Select, an online DVD rental service. The Service is known as 'Vue At Home', and gives Vue consumers the same pricing and service deal as ScreenSelect's customers. Vue sees DVD renters as key cinemagoers and is aiming to increase both cinema attendance and DVD rental.

131-1. Vue has 548 screens housed in 57 sites at end 2006, equivalent to 9.6 screens per site. Its largest individual complex is the 21 screen cinema in Birmingham. In 2006, Vue

Figure 40: Flow of funds - Vue Entertainment



Source: Screen Digest

Figure 39: History of Vue Entertainment

1933	Warner Bros Theatres Ltd incorporated for management of West End cinemas only
1987	Warner Bros Theatres UK established for nationwide chain
2003	Warner Village acquired by SBC Cinemas to form Vue Entertainment
2005	Warner Village acquired by SBC Cinemas to form Vue Entertainment
2006	Management BO (backed by Royal Bank of Scotland) from previous owners Boston Ventures, Clarity Partners and L&G

Source: Screen Digest

provided an estimated £50m in payments to distributors, retaining around £71.9m in net movie revenues. Vue Entertainment was the most profitable exhibitor in terms of average revenue per screen in 2006.

Showcase Cinemas

132. The fourth largest cinema group, Showcase, is controlled by US group National Amusements, with 244 screens in the UK.

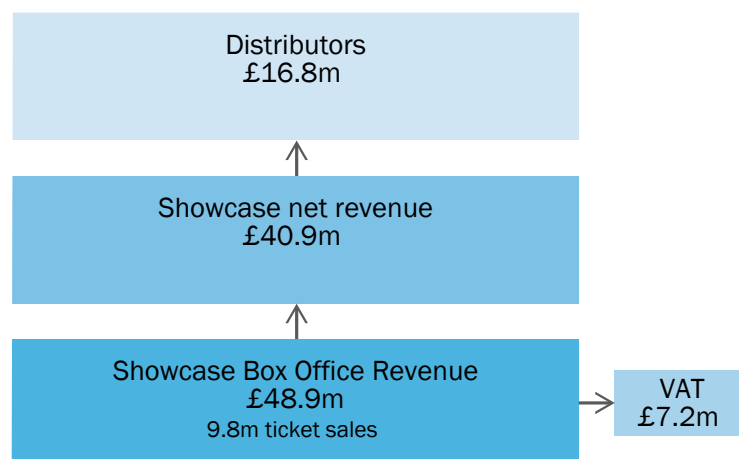
133. National Amusements entered the market in 1988 and built one of the first multiplex cinemas in the UK. It has since expanded to 244 screens, housed in 19 sites, equivalent to 12.8 screens per site, the highest average in the UK cinema sector. Its largest cinema is the 16

screen Showcase in Leeds, while its smallest has just six screens, inferring that its screen base consists entirely of multiplex cinemas.

134. National Amusements owner, Sumner Redstone, also controls 11 per cent of US media company Viacom, which in turns owns Paramount and Dreamworks SKG. National Amusements operates over 1,500 screens across the USA and Latin America and Russia. Its exhibition brands around the world include the Showcase, Multiplex, Cinema De Lux, and KinoStar movie chains. In the USA, National Amusements has screens across 12 US states.

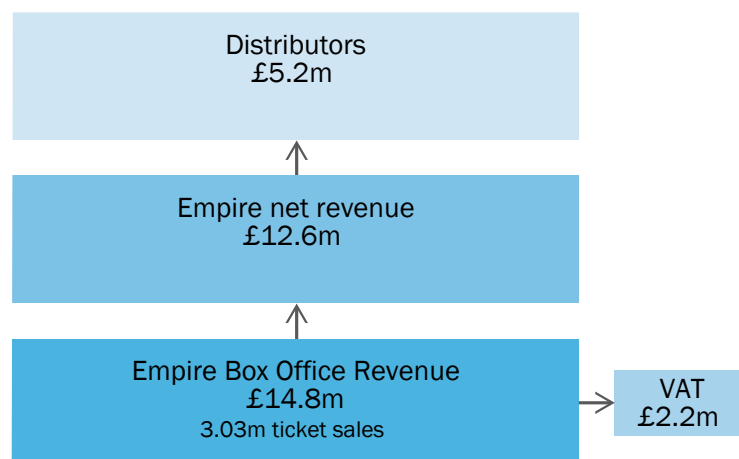
135. In 2006, Showcase retained £24.1m in movie related revenue, after £16.8m in payments to distributors for film hire arrangements.

Figure 41: Case Study flow of funds - Showcase Cinemas



Source: Screen Digest

Figure 42: Case Study flow of funds - Empire Cinemas



Source: Screen Digest

Empire Cinemas

136. Empire Cinemas was created in 2005 from the acquisition of certain sites in the UK that were divested, following the merger and acquisition activity in 2004 and 2005. The parent company of Empire Cinemas is Cinema Holdings Limited, a company controlled by Thomas Anderson, a senior member of the Ward Anderson family, which in turn controls 36 cinemas across Ireland, under the Cineplex, Omniplex and IMC brands, accounting for around 50 per cent of the box office there. Empire is the first foray outside the Irish exhibition sector for Cinema Holdings and/or Ward Anderson.

137. The group made strategic acquisitions in two stages; firstly forming Cinema Holdings Ltd to take control of 11 former Odeon UCI cinemas including the prime UCI Leicester Square venue. Cinema Holdings 2 Limited was later formed to acquire six cinemas from Cineworld for around Euro 40m (\$47.8m). The OFT ruled on 26 October 2005 and 20 December 2005 under merger decisions 2005, that the acquisitions did not warrant a full investigation under the merger provisions act of the Enterprise Act 2002.

138. Empire Cinemas operates a total of 142 screens in the UK, housed in 17 sites, and screens equivalent to an average of 8.4 per site, indicating a high provision of multiplex stock. Empire accounted for a small 1.9 per cent of the box office in 2006. Empire Cinemas has proceeded to convert one entire multiplex to digital cinema capabilities in 2007.

139. After £5.2m in payments to distributors for film rental agreements, Empire Cinemas retained £7.4m in movie revenues in 2006.

3.6 Market issues

Release windows

140. The current minimum release window from theatrical to DVD is 17 weeks. These terms have narrowed following an industry disagreement over an attempt by Twentieth Century-Fox to shorten the theatrical-to-DVD window to three months (97 days) for one title (*Night at the Museum*) in 2006, well below the accepted norm of four months. Leading cinema circuits (Vue, Cineworld, Odeon UCI and Showcase) decided to stop showing the movie, after Fox announced the DVD was set for an early release on 2 April 2007 compared to the theatrical release on 26 December 2006, thereby falling below the four month acceptable norm.

141. Fox itself says the decisions were one-offs based on seasonality, due to an early Easter. It is possible, although far from clear cut, that these are trial attempts to reduce the theatrical-to-DVD window, to test the reaction of cinema exhibitors and to establish the impact on revenues in both windows. In the UK, the theatrical-to-DVD window has been falling, from an average 31.1 weeks in 2002 to 19.8 weeks in 2005. This fall led to exhibitors and distributors agreeing a mutually acceptable 17 weeks (four months) as the shortest time period for the window. However, this drop in the window also happened at a time (2005) when a film was taking an average 44 per cent of its overall gross in the first week and 99 per cent in the first eight weeks, compared with 18 per cent and 87 per cent respectively in 1990. The current minimum of 17 weeks

is therefore very close to the lower limit of acceptability for exhibitors.

142. There have been various discussions surrounding the viability of simultaneous releasing, or the removal of all windows across all platforms. This scenario would see a film released theatrically at the same time as a DVD, VOD and even TV release. There were several early attempts at simultaneous releasing in the UK and US, mainly using independent films, although the early results show this was not particularly conducive to cinemagoing. In the US, 2929 Entertainment distributed *Bubble* a movie from producer Steven Soderbergh as a simultaneous release. The film took over \$5m in its first weekend, of which just \$72,000 came from 32 cinema screens, which is not comparable to higher budget Soderbergh titles but respectable for a micro-budget no-star indie film, as well as \$5m in DVD pre-orders and other revenues. DVD reportedly accounted for half of these revenues, and \$250,000 was attributed to a television licence fee from HDNet. The film cost \$900,000 to produce and was shot in 18 days on Sony HD cameras.

Concentration of Box Office

143. Cinema is very much a hit market. In 2006, the top 10 movies (of about 500 movies released) grossed £262.3m i.e. 31.4 per cent of the total box office that year. The top 50 films gathered 71.0 per cent of the total.

144. The top 100 films accounted for 88.6 per cent of box office revenues in the UK and Ireland, from 19.8 per cent of releases. Over 99 per cent of the box office was recorded from the top 250 films, even though they accounted for just under 50 per cent of releases. The top ten movies alone regularly account for over 30 per cent of total revenues.

Figure 43: Cinema - Leading exhibition chains in the UK

Titles	Revenue (£m)	Revenue (%)	Releases (%)	Revenue/title (£m)
Top 10	262.3	31.4	2	26.2
Top 20	390	46.7	4	19.5
Top 50	592	71	9.9	11.8
Top 100	739.2	88.6	19.8	7.4
Top 250	828.2	99.3	49.5	3.3
Total	834.3	100	100	1.7

Note: the box office total here includes UK and Ireland

Source: Screen Digest from Nielsen EDI

Looking forward - Digital Cinema

145. In terms of the film value chain, digital cinema will largely impact on the link between distribution and exhibition. There will no longer be a master 35mm print but a master digital file, which can then be copied onto hard drives or other physical media that can be transported to cinemas. The file will be played on a digital cinema system (server and projector) and will never degrade.

146. Even in the case of physical transportation of the hard drive which is currently the dominant method being deployed until a satellite or broadband network is commercially viable, the copy is usually loaded up on the cinema digital cinema server, and the disk returned to the network operator, again via standard courier services. In this way, there is a significantly reduced cost for distributors compared with the bulk of transporting traditional film prints. The advantages offered by digital distribution include the lack of a hard file (electronic copy), increased security, and potential reduction of cost barriers for theatrical distribution (P & A costs).

Digital Screen Network (DSN)

147. The UK Film Council (UKFC) has launched a major digital cinema initiative to promote wider distribution and exhibition of 'specialised' film in the UK. Specialised films have been classified as the following; foreign language films with subtitles, documentaries, classic films, and unconventional or challenging English language titles as well as UK-origin films.

148. The main aim of the DSN is to increase the audience for 'specialised' films from the current 10-12m admissions per annum by 40 per cent over the next five years, through the use of digital cinema technology. Cinemas participating in the scheme include some of the major cinema chains such as Odeon and Cineworld as well as smaller independent circuits. The Digital Screen Network (DSN), funded by £13m of UK Lottery money, installed 240 digital screens in approximately 150 cinemas in the UK. Participating cinemas are required to screen a certain percentage of these 'specialised films', but can use equipment at other times for mainstream films, digital advertising and other uses. The scheme is being managed by UK digital film company

Arts Alliance Media, and was completed by summer 2007.

DCI

149. The UKFC had requested the use of high level D-cinema equipment, known as 'DCI level' or that which is acceptable to the Hollywood Studios. Digital Cinema Initiatives (DCI) was a body set up by the major US Studios in order to evaluate appropriate standards for digital cinema technology worldwide. They released a set of technical recommendations in July 2005, highlighting various security and technical parameters such as film file compression (JPEG2000), projector resolution (minimum 2K), digital watermarking and others that would be required for any cinema to screen a Hollywood film in digital.

150. The work of DCI places a strategic value on the theatrical environment, aimed at avoiding the co-existence of several technical formats, unlike previous situations in the home cinema sector (VHS/Betamax). DCI also aimed to introduce an element of future proofing, especially considering the high level investment required (each system costs around \$90,000). Another desired outcome of DCI was total interoperability, similar to that achieved in the 35mm film world; a system that has been in operation for over 100 years.

151. It is likely that all major cinema chains in the UK will need to adopt DCI level standards for digital cinema equipment as US films account for the majority of revenues (up to 80 per cent in any given year). Smaller and independent cinemas will also need to adopt these standards in order to avoid getting left behind or going out of business altogether.

152. In the US, rapid deployment of D-cinema systems has been aided by a common business model known as the Virtual Print Fee (VPF) system, whereby Studio savings from distribution are ploughed back into paying for the equipment. Of course, the European cinema market is much more fragmented with a local film industry, smaller cinemas and independent operators to account for, and so the task of agreeing a fair business model will be much more complex and one that is currently still in progress.

Digital cinema networks

153. Digital cinema also creates a role for third party facilitators such as Arts Alliance Media, Kodak or Technicolor Digital Cinema, tasked with the investment, installation, management, training and maintenance of digital cinema networks. It is not expected that they will impact the current terms between exhibition and distribution. They will however deduct some distributor revenue (rental) and plough this back into their initial investment of the equipment through the VPF scheme as discussed above. They will also act as a central hub of the network providing the electronic keys, which are required to access each film at each individual cinema.

Impact on content and distribution

154. Digital distribution has the potential to increase flexibility in distribution and enable wider releases including more 'day-and-date' releases. It enables a quicker turn around to produce and transport a digital copy and to be able to respond better to unexpected demand (increase copies). Currently 35mm prints require a rigid planning structure for distributors and cinemas, but potential cost savings from digital distribution could be ploughed back into wider releases, an increase in the marketing budget for the film or the release of more films. The ease of digital distribution is also likely to result in the reduction of cost barriers for smaller players coming to the market, in particular independent distributors, offering a lower break-even threshold for a box office return. However, if the majority of UK screens are allied to a commercial business model, in which US distributors or major independent distributors are helping fund the transition through the payment of a VPF over a qualifying time period, the eventual time when the cost savings can be transferred to smaller players could be delayed by seven to 10 years.

155. Digital cinema certainly offers the potential for a greater variety of content to make its way to cinema screens, even in the form of local and regional programming, ie a film produced by a local director. This is also expected to help cinemas target their audience more closely.

156. At the other end of the scale, there are also likely to be films which are produced especially to be seen in digital. One form of this content, currently influencing take up of

systems is Digital 3D. The use of the digital projector makes it possible for any cinema to play specially configured 3D movies without any of the previously associated adverse side effects such as headaches and nausea. Based on initial reports that digital 3D screens received almost three times the revenue of the flat screen version, 3D is likely to remain a key driver and differential for the theatrical environment against other entertainment options.

157. Digital cinema can also be used for screening alternative content such as music or sports events, providing additional revenues for exhibitors in 'downtime'. This is not, however, expected to replace existing movie consumption.

158. There were a total of 148 D-Cinema screens in the UK at end 2006, accounting for around 4.1 per cent of the total market. Screen Digest forecasts there will be 2,800 d-cinema screens by 2010, equivalent to 75.0 per cent of the UK's screen base.

4 DVD markets

4.1 Key findings

- **Definition:** the DVD market is comprised of four sectors; offline retail, online retail, offline rental and online rental.
- **Enabled homes:** 20m households were equipped with a standalone DVD player/recorder at the end of 2006.
- **Consumption levels:** average buy rates in the offline sectors are declining but remain significantly higher than those in the online markets.
- **Window and terms:** all four DVD sectors share a release window. On average, titles are launched on DVD around 17 weeks after their cinema release
- **Value Chain:** wholesalers EUK and Handleman are important middle-men in this market, on the retail side at least. Between them they represent almost three quarters of all wholesale shipments to DVD retailers.
- **Consumer spending:** in 2006, film represented 72 per cent of the £1.3bn (VAT-net) spent on DVD retail (online and offline). On the rental side, virtually all offline spending was on film (£289m) but within the online rental space, film accounts for around 75 per cent of spending (£43m).
- **Principal Providers:** HMV and Play are the biggest players in the DVD retail market's respective offline and online sectors. On the rental side, Blockbuster (offline) and LoveFilm (online) are the top principal providers.
- **Studio revenues:** we estimate that movie rights-holders get almost 60 per cent of net consumer revenue.

4.2 Overall market data

Enabled homes

159. Eight years on from when it debuted, DVD can be considered a mass market product. In 2006, 20m homes in the UK were equipped with a standalone DVD player/recorder. This translates into 80 per cent penetration of TV households.

160. Consumer spending on video software more than doubled between 1998 (when DVD was launched) and 2006, largely due to the

huge success of DVD retail (sell-through). By comparison spending on rental has remained relatively flat despite the introduction of the new format.

Total DVD revenues (all business models)

161. Our DVD model excludes non-film product in order to directly compare revenues with other platforms. The film genre (which, for the purposes of this analysis, includes theatrically released feature-length animated titles) still accounts for the lion's share of the

DVD market despite the increase in popularity of other genres (particularly TV DVD). In 2006 film represented 72 per cent of total spending on DVD retail (online and offline) according to the British Video Association (BVA). On the rental side, virtually all offline spending is on film but within the online rental space film accounts for around 75 per cent of spending. Our forecasts assume that film will continue to account for these proportions of spending over the forecast period 2007 to 2010.

162. Revenues from the retail and rental of movies on DVD generated £1.7bn (VAT-net) in 2006. Offline DVD retail accounted for the lion's share of the market, generating 65 per cent of total DVD value at £1.1bn. Its online counterparts took around £254m (15 per cent of total DVD value). This means offline retailers represented 80 per cent of the retail DVD market and online retailers 20 per cent.

Assuming that this remains the case over the forecast period, we expect revenues from both sectors to remain stable.

163. On the rental side, it is again the offline sector which dominates the market. In 2006 offline DVD rental generated £289m, giving it an 87 per cent share of DVD rental revenues (17 per cent of total DVD value). Online DVD rental services accrued £43m by comparison to account for the remaining 13 per cent of rental revenues (three per cent of total DVD value). However, we expect DVD rental-by-post to increase its share of the market between 2007 and 2010. By the end of the forecast period we anticipate that online DVD rental will represent over a third of revenues.

Buy rates

164. DVD buy rates in the offline sectors have slowed in recent years. On the retail side, this is an indication of market saturation - consumers have built up their DVD libraries over several years so no longer continue to buy at the same rate. It is also a reflection of the arrival of late adopters in the DVD market, a category of consumer which has historically been less enthusiastic about content than early adopters. Buy rates in the offline rental market have fallen at a faster rate than their retail equivalents - this is evidence of the general trend of decline in offline rental transactions.

165. Buy rates in the online sectors have been more stable over the period assessed. This is due to the fact that transactions through these channels are still increasing - albeit at a modest rate - whilst growth in the offline sectors has stalled.

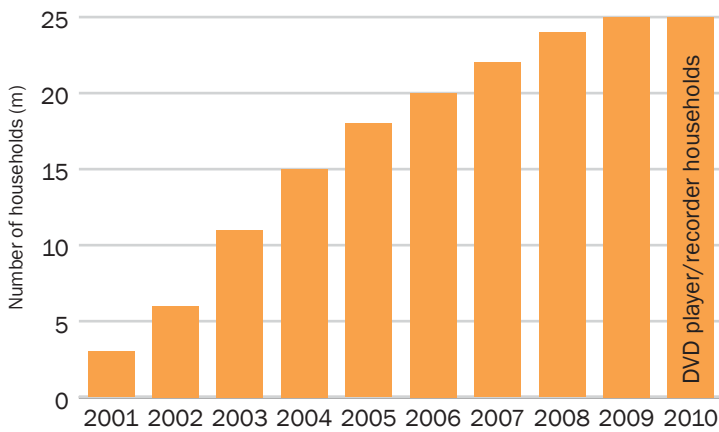
Retail environment

166. Retailers in the UK can be broadly split into two different categories: those that are supplied directly by distributors and those that source their stock through a wholesaler.

Direct supply

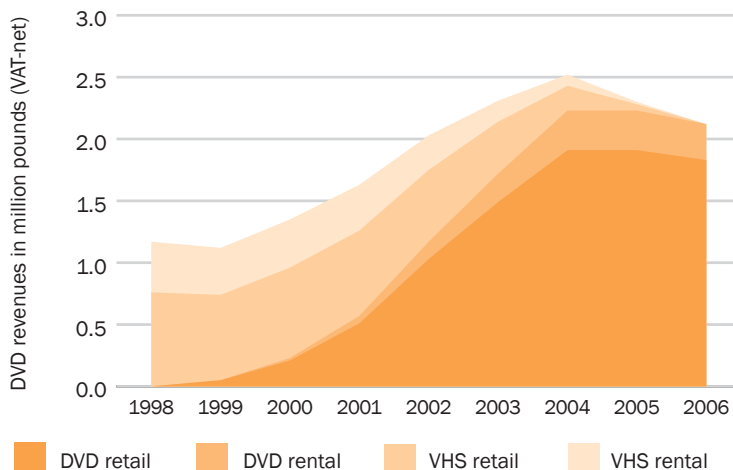
167. Traditionally, if a retailer is supplied video product directly by a distributor, the retailer is responsible for managing the stock into store. This system is still used by leading chains such as HMV. However, in recent years some retailers have entered into a Vendor Managed Inventory (VMI) relationship with distributors under which the distributor effectively takes

Figure 45: DVD Enabled households



Source: Screen Digest/DVD Entertainment Group

Figure 44: DVD - Total video revenues (£m)



Source: BVA

over responsibility for managing each store's inventory level. The VMI system also handles the scale-out and replenishment of titles. Thus for VMI accounts the distributor takes a much more active role, not only in selecting the range of product stocked but also in the

planning of promotional activity, in-store merchandising and the processing of returns. Currently the only major UK retailers which are understood to have VMI relationships are Asda and WH Smith although we anticipate that this approach is likely to increase in popularity in the near future.

Figure 47: DVD - Buy Rates

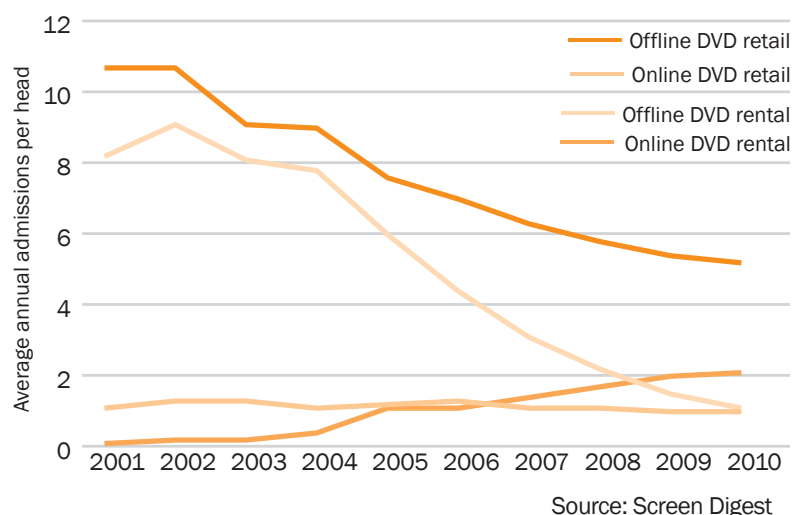


Figure 48: DVD - Revenues by sector (£m)

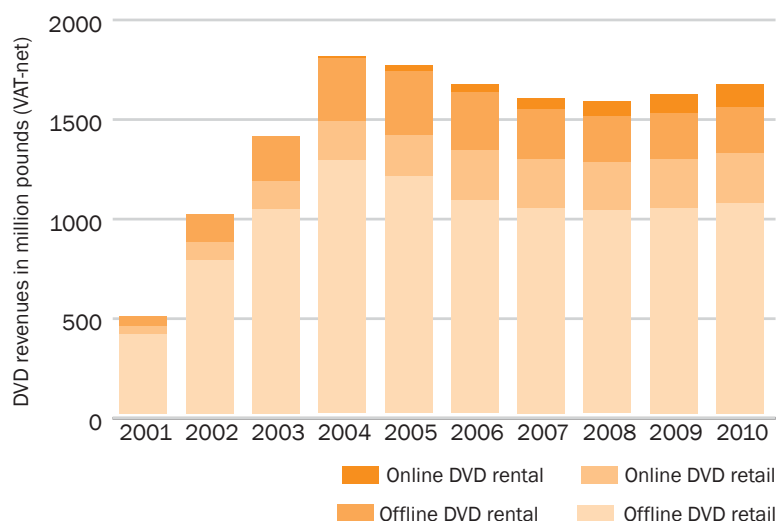


Figure 46: DVD - Revenues by sector (£m)

		2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Offline DVD retail	£m	399	771	1,026	1,269	1,189	1,069	1,030	1,018	1,032	1,057
Online DVD retail	£m	37	88	136	198	210	254	245	242	245	251
Offline DVD rental	£m	55	141	228	318	321	289	252	235	228	227
Online DVD rental	£m	-	1	2	10	29	43	55	75	100	117
Total	£m	491	1,000	1,393	1,796	1,748	1,655	1,581	1,570	1,605	1,652

Source: Screen Digest analysis of BVA data

Wholesale supply

170. Our analysis shows that six of the principal providers of DVD retail are supplied by third party wholesalers. Retailers usually buy from wholesalers either because they prefer the added service that some wholesalers provide or because they are too small to qualify for direct supply (with or without VMI) from the distributors. In the UK there is also a small number of big wholesalers, such as EUK and Handleman, that focus on supplying not independent retailers, but large retail chains such as Asda and WH Smith.

171. Some retailers, particularly supermarkets, prefer the 'one-stop-shop' that such a wholesaler provides. One of the basic advantages of wholesale supply is that wholesalers send all products in a single delivery whereas with direct supply the retailer will receive separate deliveries and invoices from each distributor, which can be time-consuming for those on the shop floor. Wholesalers also combine all the merchandising and marketing activity for

different distributors, which is useful for retailers for whom home entertainment is only one aspect of their business. Some retailers may also be reluctant to go direct as this can lead to pressure from distributors to take a bigger range of their titles, rather than allowing the wholesaler or retailer to 'cherry-pick' from each release slate.

172. Due to the volume of stock that the wholesalers purchase on new release and catalogue, wholesalers are understood to benefit from substantial discounts on DVDs purchased from distributors. According to industry sources the cost of a disc to the wholesaler can be up to 25 per cent lower than the recommended dealer price. The wholesaler then adds its own mark-up of around eight per cent when the stock is sold on to its clients. However the wholesaler incurs additional distribution and merchandising costs to get the stock into store and on the shelf.

173. In theory, once stock has left the wholesaler, the retailer is responsible for any unsold stock that may be left in its stores. However a large wholesaler such as EUK will also undertake to uplift stock from its key clients in order to maintain effective in-store ranges. The wholesaler can then choose to re-distribute the stock where it will be most effective. Often overstocked titles that have been returned to the wholesaler will be included in subsequent promotional campaigns. Wholesalers are subject to a 'returns allowance', in much the same way as retailers who deal directly with distributors, however large volumes of stock are often returned by the wholesaler to the distributor in order to facilitate the influx of new product.

174. The cost of buying retail DVDs from a distributor or wholesaler varies considerably according to the size of the retailer and the copy depth (the number of units of each title in stores) it acquires. Economies of scale mean that a major retailer such as HMV will secure a considerably greater discount on the standard dealer price (DP) than a small independent. This means that smaller retailers often have a hard time competing with larger chains on price. Indeed, it is not unknown for some independent retailers to buy a proportion of their stock from bigger retailers, as this can be cheaper than buying from a wholesaler. The discount each retailer is offered also depends on the type of account that it has. For example the studio may offer better terms of discount

Figure 49: DVD - Principal providers' retail supply

Direct	Wholesale
Amazon	Asda
Blockbuster	Morrisons
HMV	Sainsbury
Play	Tesco
Virgin	WH Smith
	Woolworths

Source: Screen Digest

Figure 50: DVD - Wholesaler market shares

Wholesaler	Retailer	Market Share
EUK	Woolworths	22%
EUK	Tesco	25%
EUK (VMI)	WH Smith	6%
Total EUK		53%
THE	Music Zone	4%
THE	Sainsbury	6%
THE	Morrisons	8%
Total THE		18%
Handleman	Asda	17%
Total Handleman		17%
Others		12%

Notes: Based on 2006 volume sales data

Source: Screen Digest analysis of BVA/TNS data

if the studio and the retailer agree to enter a VMI relationship. If a retailer is supplied by a wholesaler then it can expect to be charged a slightly higher price than if it sources product direct from a studio. However, as noted above, there are a number of benefits for retailers who opt for wholesale supply.

175. Entertainment UK (EUK), a subsidiary of Woolworths Group, dominates the DVD wholesale sector in the UK. It counts sister company Woolworths, WH Smith and Virgin (as of mid 2007) as clients. In September 2006 EUK acquired rival Total Home Entertainment (THE) and its portfolio which included supermarkets Sainsbury, Somerfield and QuickSave. Handleman is another key player. In March 2006, Tesco, the UK's leading supermarket announced its intention to switch its video supply from EUK to Handleman. Based on the wholesalers' market shares in 2006 this will leave the market relatively evenly split between the two key players, with EUK accounting for approximately 37 per cent, Handleman around 34 per cent, and the remaining portion of the market divided up amongst a handful of other smaller wholesalers.

Retailer types

Offline

Audio-visual specialists

176. The UK boasts a highly concentrated audio-visual specialist sector, with a small number of specialist retailers - HMV, Virgin and Blockbuster amongst them - commanding the majority of the market share. Most of the audio-visual specialists in the UK operate relatively large stores, often located in busy high streets, and devote a substantial proportion of their shelf space to DVD. The range of titles stocked by specialist retailers is inevitably more extensive than that found in other retail sectors and as such they tend to become destination stores for buying catalogue DVDs as well as new releases. Although it is possible to find cheaply-priced DVDs in specialist stores, these titles tend to be part of either retailer- or studio-led promotions – which occur frequently in this type of store. However, when it comes to new releases, the audio-visual specialists tend not to get involved in the aggressive price promotions which characterise other retail sectors. Retailers

in this sector also tend to stock a significant number of premium priced specialist and cult titles which are not generally available in other offline retail channels, making the availability of such non-mainstream titles part of their attraction to their core customers.

Supermarkets

177. The UK supermarket sector is centred around four large, highly-competitive retail groups, Tesco, Asda, Sainsbury and Morrisons (which acquired Safeway stores in 2004). In the last few years the leading supermarkets have all developed Internet shopping sites, home delivery and a range of store formats in order to keep pace with changes in customers' shopping habits.

178. In terms of total sales, Tesco is the market leader and its aggressive pricing policies have put pressure on not only smaller supermarkets but also its major competitors. In recent years Tesco has acted through acquisition to strengthen its position in the convenience store segment. In addition to being overall market leader in terms of total sales, Tesco is also the leading DVD retailer in this sector with a 12 per cent share of total sales by volume in 2006 compared to Asda's eight per cent. However the importance of Asda which is part of the biggest retailer in the world, Wal-Mart, should not be underestimated. Sainsbury's and Morrisons do not focus on home entertainment to the same degree as the other two supermarkets do, with a market share of around seven per cent between them.

179. The supermarkets tend to stock a relatively small range of titles in most of their stores; however certain stores, particularly the larger hypermarkets or those which specialise in non-food, carry a more extensive range. Given the supermarkets' target customer, the DVD range stocked is generally biased towards children's and family titles but they usually stock most major new releases as well. Supermarkets in the UK are very price aggressive, with most DVD titles generally sold for £1 or £2 less than they can be bought for at specialist stores. In the UK there are no laws regarding selling below cost and as such it is not unknown for a supermarket to sell high profile titles at little or no profit margin, in order to drive footfall.

Figure 52: Offline DVD retail - Market data

		2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
revenues	£m	399	771	1,026	1,269	1,189	1,069	1,030	1,018	1,032	1,057
average DVD price	£	12.38	11.5	10.29	9.38	8.8	7.6	7.54	7.61	7.82	8.16
unit sales	m	32	67	100	135	135	141	137	134	132	130

Source: Screen Digest analysis of BVA data

Figure 51: DVD retail - Retailer market shares

		2001	2002	2003	2004	2005	2006
HMV	%	17	18	16	17	17	17
Virgin	%	8	8	8	6	7	8
MVC	%	6	4	4	3	2	2
Our Price	%	3					
Sanity	%		2	1			
Music Zone	%				1	2	2
Blockbuster	%	2	3	3	3	2	3
Silverscreen	%				1	2	
Other Specialists	%		6	5	5	5	5
Total specialists	%	35	40	36	37	36	37
WH Smith	%	12	6	6	5	4	3
Woolworths	%	13	13	13	13	11	11
Dixons Group	%	2					
Other Chains	%		2	1	0	0	0
Total generalists	%	26	21	19	18	16	13
Asda	%	5	6	7	8	8	8
Tesco	%	7	6	8	9	11	12
Safeway	%	1	1	2			
Sainsbury	%	1	2	2	3	3	3
Morrisons Group	%		1	2	3	4	4
Somerfield Group (inc. Kwiksave)	%					1	1
Other supermarkets	%	1	0	1	1	1	1
Total supermarkets	%	13	16	21	24	27	29
Other Offline	%	18	13	11	10	8	4
Amazon	%		2	3	4	5	5
Play	%		4	3	4	5	6
Other Online	%	9	4	5	4	4	6
Total offline		92	90	88	88	87	83
Total online		9	10	12	12	13	17

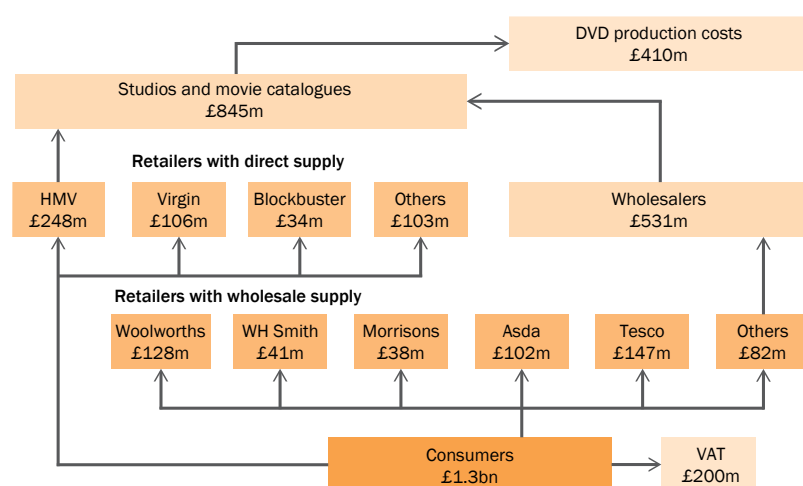
Notes: 1. Based on 2006 volume sales data
 2. Our price included in Virgin share from 2002
 3. MVC share in 2006 is based on Music Zone's share
 4. Safeway included in Morrisons Group share from 2004

Source: Screen Digest analysis of BVA/TNS data

Generalists

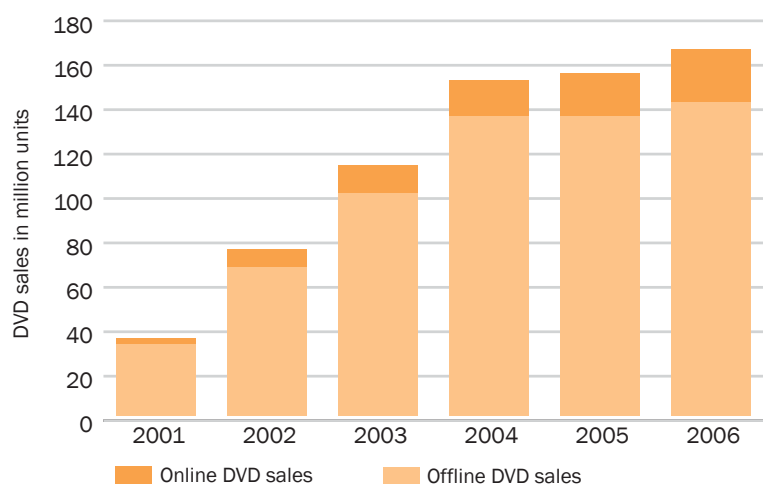
180. The generalist sector still remains an important DVD sales channel in the UK despite the fact that it has been haemorrhaging market share to the supermarkets and specialist sectors over the last few years.

Figure 54: Offline DVD retail - Cash flow chain (2006)



Source: Screen Digest analysis of BVA/TNS data

Figure 55: DVD retail - Share of offline vs. online



Source: Screen Digest analysis of BVA data

Figure 53: Offline DVD retail - Share of total DVD retail

		2001	2002	2003	2004	2005	2006
offline DVD unit sales	m	32	67	100	135	135	141
offline sales as % total sales	%	92	90	88	90	87	86
online DVD unit sales	m	3	8	13	16	19	24
online sales as % total sales	%	9	10	12	10	13	14
total DVD unit sales	m	35	75	113	151	155	164

Source: Screen Digest analysis of BVA data

The sector is more or less divided between two key retail chains, Woolworths and WH Smith, which between them accounted for 13 per cent of DVD sales by volume in 2006. Woolworths, which was once the market leader for video in the UK, managed to hold on to the number three spot in 2006, but WH Smith, once the second largest video retailer has since slipped into eleventh place. Woolworths is a high street variety store pitched towards the lower end of the mass market whilst WH Smith is a destination store for magazines, books and stationery. In terms of pricing, the generalists have more in common with the specialists than the supermarkets although they will occasionally take a big hit on margin to promote certain high profile titles.

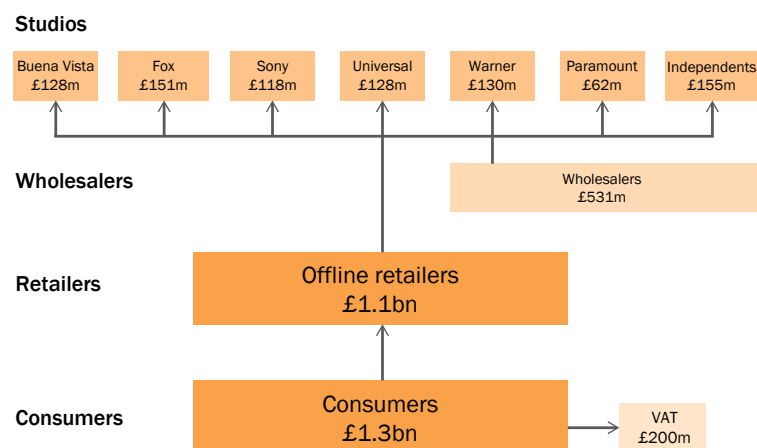
Online

181. The importance of the Internet as a retail channel is growing every year. According to British Video Association (BVA) analysis of data from TNS, the proportion of DVDs sold over the Internet rose from nine per cent in 2001 to almost 17 per cent in 2006. The biggest players in this sector are Amazon (in both its UK and US incarnations) and Play.com which between them accounted for over two thirds of the total online DVD sales in 2006. Many of the leading UK retailers such as HMV, Asda and Tesco also offer their own Internet shopping services, however the combined Internet sales of companies outside the two key players is believed to amount to no more than six per cent of the total DVD market.

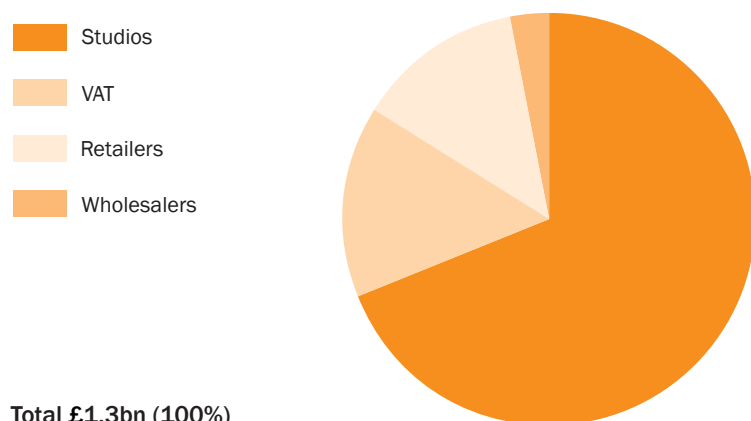
4.3 Offline DVD retail

Offline DVD retail revenues

182. This sector is the biggest contributor to the DVD market. In 2006, consumers

Figure 56: Offline DVD retail - Studio revenues breakdown

Source: Screen Digest analysis of BVA/TNS data

Figure 57: Offline DVD retail - Share of gross revenue

Total £1.3bn (100%)

Source: Screen Digest

spent £1bn (VAT-net) on buying movies on DVD through traditional 'bricks and mortar' stores, which accounted for 65 per cent of total spending DVD film spending. This represented a 10 per cent decline in spending on 2005, due largely to an ongoing decline in average prices.

183. Sales of movies on DVD through offline retailers continued to climb in 2006, rising by four per cent from 135m units in 2005 to 141m units in 2006. Sales of DVD feature films through online retailers showed much stronger growth than those through the offline sector, rising by 26 per cent. Consequently, online retailers' share of DVD film sales expanded from 13 per cent in 2005 to 14 per cent in 2006, eroding that of offline retailers. Nevertheless, traditional 'bricks and mortar' outlets remain the dominant retail distribution channel.

Cashflow chain and margins

184. Offline DVD retail generated gross consumer spending on movies of £1.3bn in 2006, of which retailers made net revenues of £1.1bn. Approximately £531m (48 per cent) of this went through a wholesaler. Overall, production studios received £845m from offline DVD retailers which equates to 65 per cent of gross revenues.

Principal Providers

185. The UK video market has traditionally been dominated by a small number of

Figure 58: DVD retail - Retailer market shares

Retailer	Category	Share of offline DVD retail (%)	Share of total DVD retail (%)
HMV	Specialist	21	17
Tesco	Supermarket	14	12
Woolworths	Generalist	13	11
Virgin	Specialist	9	8
Asda	Supermarket	10	8
Morrisons	Supermarket	4	4
Blockbuster	Specialist	4	3
Sainsbury	Supermarket	4	3
WH Smith	Generalist	3	3
Other specialists		8	7
Other generalists		0	0
Other supermarkets		2	2
Other Outlets		8	5
Total offline		100	83

Notes: 1. Based on 2006 volume sales of all DVD
Source: Screen Digest analysis of BVA/TNS data

specialists such as HMV and Virgin and two major generalist chains; Woolworths and WH Smith. However in recent years the supermarkets have been extending their non-food ranges considerably and have made video an increasingly important part of their product mix. Tesco's ascension in the DVD market is evidence of supermarkets' emergence as a key retail channel for DVD. In 2006 it boasted the second largest share of DVD sales in the UK. In general supermarkets have increased their market share at the expense of generalists whose proportion of the video market has been declining steadily over the last six years. Woolworths used to be the UK's biggest video retailer but music and video specialist HMV now accounts for the largest share of video sales partly due to its early emphasis on DVD in its in store mix.

HMV

186. Specialist retailer HMV is not only the biggest player in the audio-visual sector but also has the biggest market share of any single retailer in the UK, accounting for 17 per cent of all film DVD sales in 2006 according to SD analysis of data from TNS. Its market share rises to 21 per cent when looking at the offline market only. The HMV music group, which also owns the Waterstone's book store chain, achieved combined sales of more than £1.8bn in financial year 2006. The retailer operates 223 stores in the UK and Ireland and is also active abroad in the Far East (mainly Japan) and Canada, with one store in the US although it sold its Australian subsidiary to Brazin in September 2005. In addition to its brick and mortar outlets, HMV also operates an online store offering DVD, CDs and games and in 2005 began offering music for download in a new service branded HMV Digital. The retailer is planning to expand this service to include movies and other video content going forward.

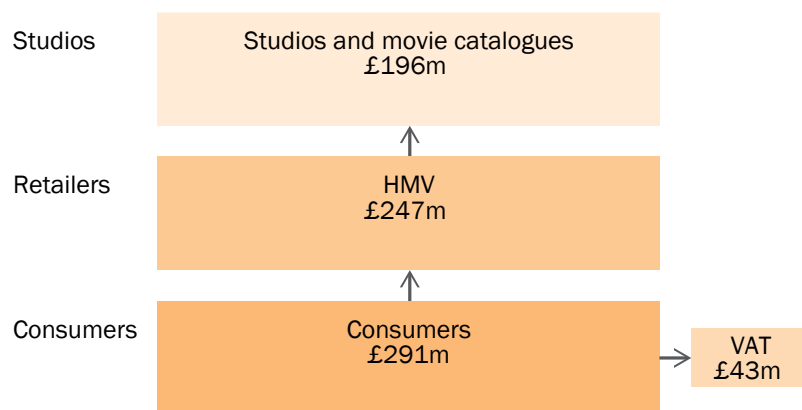
Tesco

187. Leading UK supermarket Tesco is something of a retail giant – in 2005 it became the first UK retailer to report annual profits of over £2bn. It can now also be considered a key retailer for DVD after boasting the second largest share of the DVD retail market in 2006, representing 14 per cent of offline unit sales and 12 per cent of the total market. Tesco - and indeed the rest of the supermarket sector - has seen its market share rise steadily in recent years - in 2001 it accounted for seven per cent of sales. The retailer has around 735 stores in the UK and also operates an e-tail service online which includes DVDs. Tesco is looking to consolidate its position in the home entertainment market with the launch of a film download service which will complement the music download offering that it launched in November 2004. Tesco is also involved in online DVD rental via a 'white label' rental-by-post partnership with LoveFilm International.

Woolworths

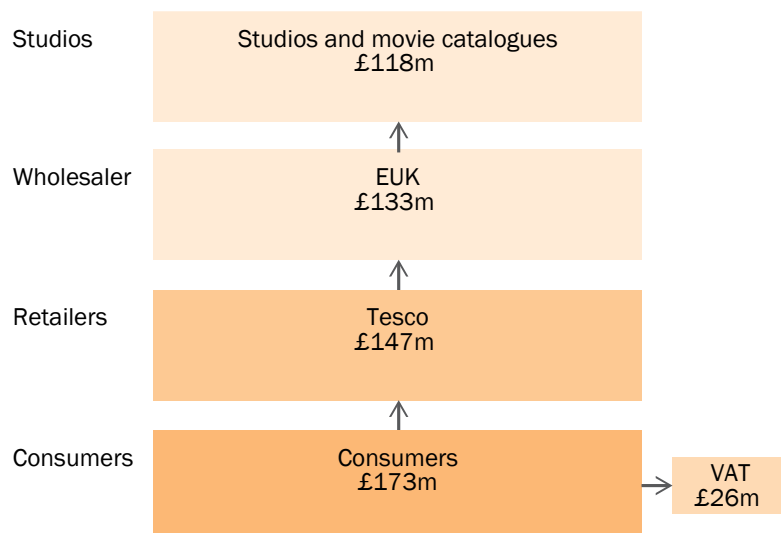
188. Generalist retailer Woolworths has seen its market share of DVD sales eroded slightly from 13 per cent in 2001 to 11 per cent in 2006. Nonetheless, with a footprint of around 820 stores, it remains one of the UK's key DVD retailers, boasting the third largest market share in 2006. Woolworths benefits

Figure 59: Offline DVD retail - HMV in the value chain

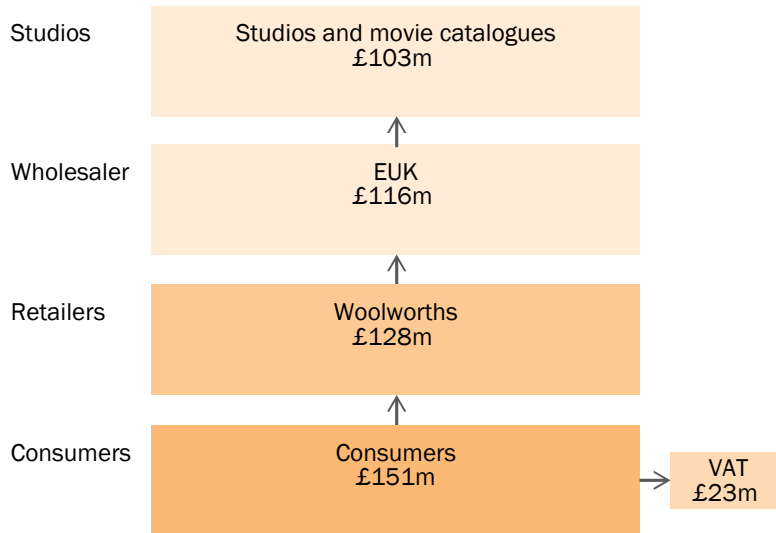


Source: Screen Digest analysis of BVA/TNS data

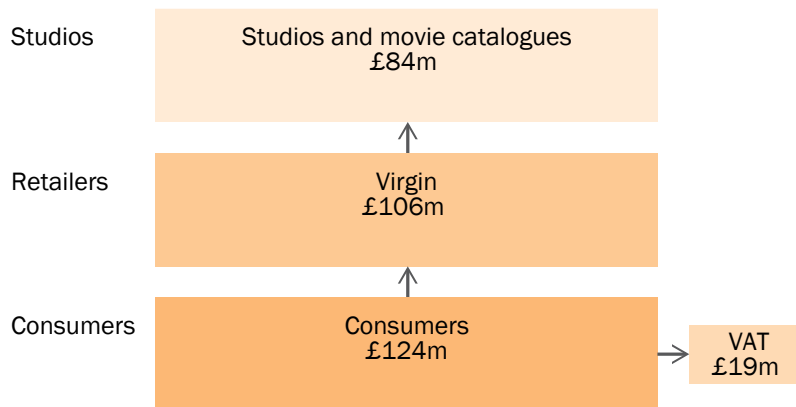
Figure 60: Offline DVD retail - Tesco in the value chain



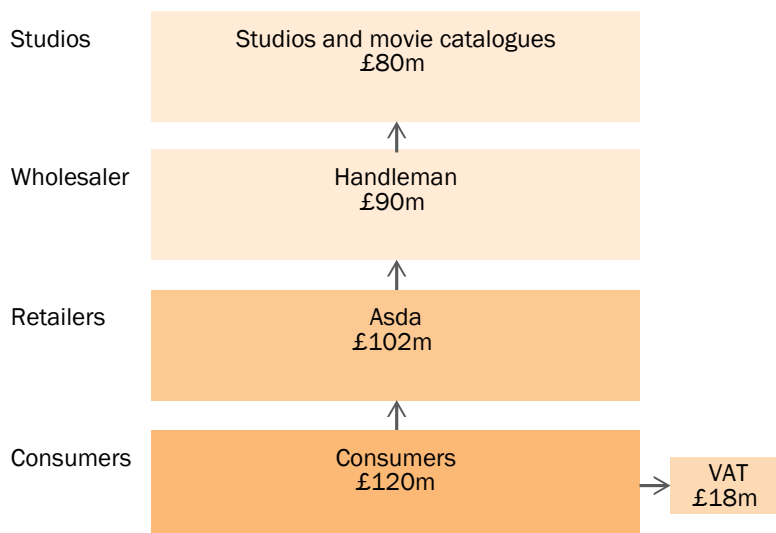
Source: Screen Digest analysis of BVA/TNS data

Figure 61: Offline DVD retail - Woolworths in the value chain

Source: Screen Digest analysis of BVA/TNS data

Figure 62: Offline DVD retail - Virgin in the value chain

Source: Screen Digest analysis of BVA/TNS data

Figure 63: Offline DVD retail - Asda in the value chain

Source: Screen Digest analysis of BVA/TNS data

from its link with fellow Woolworths Group subsidiary and wholesaler EUK, which gives it the potential to negotiate favourable DVD supply terms. The retailer also had ties to audio-video specialist retailer MVC until the latter was sold off by the Woolworths Group to private investors for £5.5m in August 2005. The chain later collapsed, with some of its outlets being acquired by Music Zone which also went out of business after going bankrupt in December 2005.

Virgin

189. Virgin was the second largest audio-visual specialist retailer in the DVD market and the fourth largest overall in 2006 with an eight per cent share of DVD sales. The 120-store chain currently deals directly with DVD distributors however, from June 2007 it will be supplied via EUK after agreeing a three-year deal with the wholesaler in January 2007. Like most of its competitors in the DVD market, Virgin's offering is two-fold, having around 125 brick and mortar stores in the UK and Ireland, and an online service. The latter includes a download service for music and games that could potentially be expanded to include movies as well as other video content.

Asda

190. Asda, a subsidiary of the US-based Wal-Mart group since 1999, was the UK's fifth largest video retailer in 2006, with a market share of eight per cent. Like its parent, Asda has long traded on its value-for-money image with DVD no exception. Indeed, in January 2007 Asda began retailing a DVD player for just £9.00, less than the average price of a DVD which, in 2006, was around £9.50. The retailer put around 80,000 of the Durabrand 1005 DVD players into its stores, expecting to sell out within two days. Durabrand is a brand exclusive to Wal-Mart so the hardware was available only in Asda stores. Asda operates around 320 stores in the UK, as well as an online service which includes DVD in its product mix. Wholesaler Handleman supplies Asda with DVD product and the retailer also benefits from a VMI relationship with a number of the major Studios.

Morrisons

191. UK supermarket group Morrisons, which took over Safeway supermarkets in March 2004, is the fourth largest supermarket group in the UK and accounted for four per cent

of the DVD market in 2006. Like the three other supermarkets profiled here as principal providers, Morrisons is supplied with DVD product via a wholesaler, namely EUK. The partnership applies to catalogue product only as the supermarket sources new releases from distributors directly.

Blockbuster

192. Key players in the UK video rental sector, Blockbuster included, are increasingly shifting the emphasis of their business from rental to retail in order to combat the fall in consumer demand for traditional offline rental. In mid 2004 Blockbuster started a rebalancing process in two trial stores with the focus on providing a strong retail offer alongside its core rental business which was subsequently rolled out across all of its 695 stores. Blockbuster is one of many rentailers which sells on previously viewed titles (PVTs) when a title is no longer new enough to justify retaining a high number of units on the shelves. However, revenues from PVTs have no impact on distributor level revenues and are not included in industry assessments of consumer spending on rental, therefore they have been excluded from our analysis. The same goes for DVD trading - the practice of accepting used videos from consumers in return for cash or store credit - in which Blockbuster also engages.

Sainsbury's

193. At three per cent, Sainsbury's had the smallest DVD retail share of all the supermarkets in 2006. This is perhaps a reflection of the importance that Sainsbury places on home entertainment as part of its product mix, at least in relative terms compared with the likes of Tesco and Asda. Indeed, the retailer recently opted to exit the rental side of the DVD business - it had been offering rent-by-post in association with LoveFilm. As is the case for its competitors in the supermarket sector, Sainsbury's DVD product is supplied via a wholesaler. THE had been its wholesale partner but following

its acquisition by EUK, Sainsbury's is now effectively supplied by the latter. In addition, EUK is responsible for Sainsbury's category management.

WH Smith

194. Generalist retailer WH Smith has streamlined its business in recent years, exiting the US and Asia Pacific markets over 2003 and 2004 in order to focus on developing its domestic retail business. WH Smith's share of DVD sales has declined steadily in recent years - arguably as a result of the retailer's former, broader strategy - falling from 12 per cent in 2001 to just three per cent in 2006. However, in May 2006 the retailer expanded its music distribution deal with wholesaler EUK, moving away from direct accounts with DVD distributors. The move, which was designed to consolidate the retailer's supply chain of entertainment product in order to increase efficiency and lower costs, could help reverse the downturn in WH Smith's share of UK DVD sales. The move was significant given as WH Smith had been one of the studios' most important direct accounts. Moreover, WH Smith was one of the few retailers in the UK, along with supermarket chain Asda, to have a VMI relationship with distributors such as Warner, Universal and Fox.

4.4 Online DVD retail

Total online DVD retail revenues

195. Sales of movies on DVD through online retailers showed strong growth in 2006, rising by 26 per cent from 19m in 2005 to 24m in 2006, outpacing the four per cent growth in sales through brick and mortar stores. The e-tail space has been less susceptible to the effects of declining prices than the offline sector - the average DVD price was stable over 2006 - which means spending has risen in line with unit sales.

196. It should be noted that except in the case of major players like Amazon, where

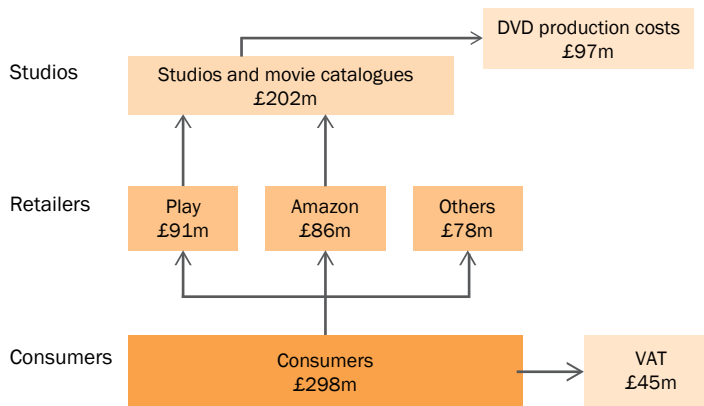
Figure 64: Online DVD retail - Market data

		2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Revenues	£m	37	88	136	198	210	254	245	242	245	251
Average DVD price	£	12.38	11.50	10.29	12.62	10.77	10.73	10.65	10.75	11.05	11.52
Unit sales	m	3	8	13	16	19	24	23	23	22	22

Source: Screen Digest analysis of BVA data

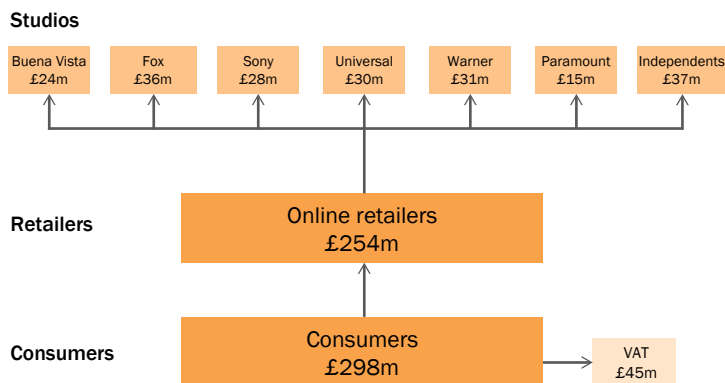
sales through its US site are counted, we do not include units purchased through offshore retailers in our numbers. In any case, we believe sales through such channels are relatively insignificant so would not affect overall market trends.

Figure 65: Online DVD retail - Cash Flow Chain (2006)



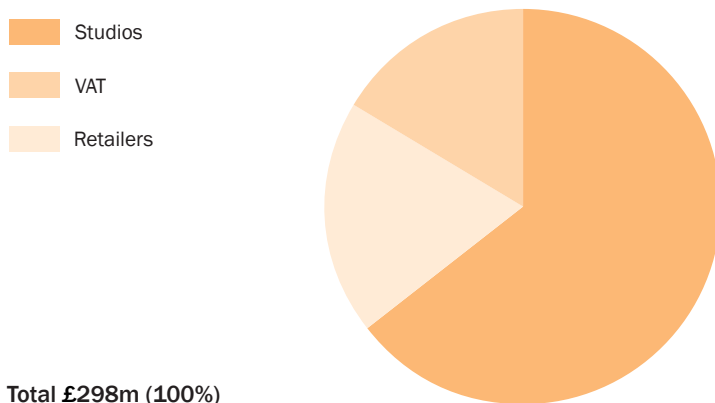
Source: Screen Digest analysis of BVA/TNS data

Figure 67: Online DVD retail - Studio revenues breakdown



Source: Screen Digest analysis of BVA/TNS data

Figure 66: Online DVD retail – Share of gross revenue



Source: Screen Digest

Cashflow chain and margins

197. Of the £298m UK consumers spent on DVD retail through online stores in 2006, retailers received £254m. Studios' share of these revenues was around 79 per cent, that is to say around £202m.

198. In terms of gross revenues, with consideration to VAT, movie rights-holders account for more than two thirds of value, with retailers retaining 18 per cent of sales.

Principal Providers

199. The online DVD retail sector is something of a duopoly with Play and Amazon accounting for around one third of the market each. The remaining third of the market is split amongst a range of e-tail services, including the e-tail arms some of the principal providers involved in the offline DVD retail business. It is no coincidence that both the leaders in the online DVD retail sector are out-and-out retailers. Evidently, the fact that Amazon and Play are not concerned with bricks and mortar retailing works in their favour in the online space.

Play

200. UK online retail start-up Play overtook Amazon in 2006 to become the leading e-tailer of DVD, accounting for six per cent of all DVD film sales and 36 per cent of DVD film sales through online stores. Launched in 1998, Play specialises in home entertainment with DVD being a core part of its product mix. The retailer sources its product direct from distributors and has a reputation for 'grey product'. That is to say, it has been reported that Play imports non-UK product for sale in the UK and buys up wholesaler overstock.

Amazon

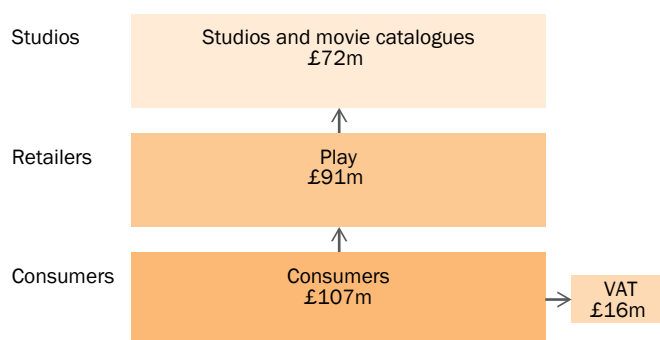
201. Combined sales of DVD through US e-tail giant Amazon and its dedicated UK portal earned Amazon a 32 per cent share of the online market and a five per cent share of all UK DVD sales including those through offline retailers. Amazon's US and UK services accounted for one per cent and four per cent respectively in 2006. In the UK Amazon maintains a relationship with DVD distributors, sourcing product direct although it occasionally employs EUK as a middle man. In addition to DVD retail through the post, Amazon offers DVD on a subscription rental basis. It is possible that, down the line, it could

Figure 68: Online DVD retail - Market share by retailer

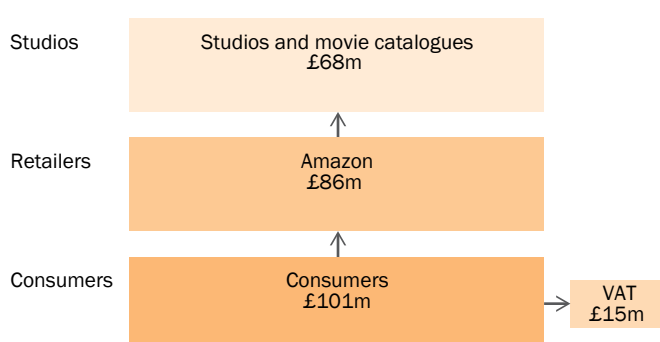
Retailer	Share of online DVD retail (%)	Share of total DVD retail (%)
Play	36	6
Amazon	32	5
Other Outlets	34	6
Total online	100	17

Notes: Based on 2006 volume sales of all DVD

Source: Screen Digest analysis of BVA/TNS data

Figure 69: Online DVD retail - Play in the value chain

Source: Screen Digest analysis of BVA/TNS data

Figure 70: Online DVD retail – Amazon in the value chain

Source: Screen Digest analysis of BVA/TNS data

also distribute movies digitally after setting a precedent in the US with the launch of digital retail and rental service Unbox in October 2006.

4.5 DVD Retail: Market-specific issues

New release v. catalogue

202. The big difference between new release and catalogue for retailers is price. Whilst an average catalogue title retails at just over £8, new release titles fetch, on average, about £12.50. And because a retailer makes roughly the same margin on all the DVDs it sells

(around 12 per cent), new release is much more profitable than catalogue. On average, a catalogue title brings in a net profit of just under £1 and a new release around £1.50.

203. The fact that new release is more profitable than catalogue means that some bricks and mortar retailers are reluctant to devote floor space to older titles. This trend is especially pronounced in non-traditional outlets for DVD, such as grocers. In these retailers audio-visual product is fighting a constant battle for space against other retail categories such as food and clothing. Furthermore these retailers sometimes eat into their own profit margins on new releases by pricing the biggest titles very aggressively and attempting to undercut everywhere else on the high street. This strategy increases footfall in store and encourages the sale of its other products. This is in stark contrast to audio-visual specialists such as HMV and Virgin. These retailers maintain their margins on new release but profit from being a destination store for film enthusiasts by supplying a large range of catalogue and specialist titles. But even the largest specialist outlet cannot compete with the potential range of catalogue of an online retailer. Their 'elastic walls' preclude them from the pressure on shelf space experienced by bricks and mortar retailers. For those retailers that focus on home entertainment – principal providers Play and Amazon for instance – the breadth of titles available in their online stores is their unique selling point (USP).

The long tail

204. In 1997, the year before DVD was launched, 5,349 titles were released into the video market. By 2005 the annual release slate had increased by 62 per cent to 8,679 titles with the DVD format acting as a catalyst for growth. The increase is not due to a rise in the number of new releases from the major Studios, it is instead an indication of the

explosion in catalogue product, independent titles and niche product. The broader range of titles available in the market has seen sales spread – in 2001 the top 30 titles accounted for a quarter of sales but represented just 13 per cent of sales in 2006. This is evidence of the long tail, the concept that a wider array of titles, catering for niche markets, will attract to a broader consumer base.

205. Online retailers are better positioned than their offline counterparts to exploit the long tail thanks to their ‘elastic walls’. The architecture of the online environment is another advantage afforded to retailers, allowing them to monitor user patterns which they can then exploit to direct consumers to other titles they may be interested in.

Release windows

206. The window between cinema and retail video release has narrowed in recent years with the arrival of DVD, and its impact on the retail video market, being the key driver. The strong growth in spending on retail video – a more profitable platform than cinema – following the launch of DVD has encouraged distributors to bring the retail video window forward. This has been manifested not in the chronology of the value chain – generally titles are still released on cinema before being launched on DVD – but in the length of the time between a title’s release into the respective distribution channels.

207. In the traditional value chain, a title would be released at cinemas, before being released for rental six months later, and then for retail a further six months later. This

model was designed to maximise potential revenues at each stage. However, with DVD, and the value it was generating in the retail window, distributors were compelled to revise their release strategy. Moreover, distributors want to make the most of their marketing budgets, exploiting the buzz generated by a theatrical release to drive DVD sale. This is substantiated by Universal’s decision in the US in February 2007 to hand responsibility for DVD marketing to its theatrical team.

208. As a result, there has been a trend of compression between the cinema and video window, with the biggest change coming in 2003 when all the major Studios abolished the video rental window in the UK (and the rest of Europe), moving instead to a simultaneous, ‘day and date’ release for both rental and retail. Our analysis of release schedules for a sample slate of titles showed that, on average, the number of weeks between a title’s theatrical and DVD release fell from around 31 in H1 2002 to just over 17 at end of 2005.

4.6 Offline DVD rental

4.6.1 Rental environment

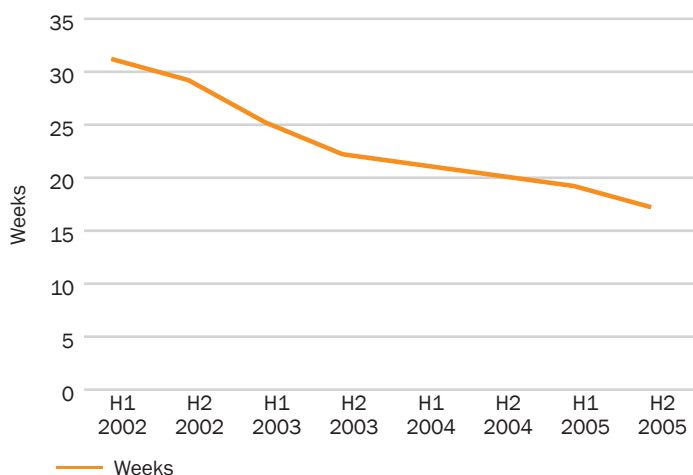
209. EUK, one of the larger DVD wholesalers in the UK (see Wholesale supply section above) is not involved in the distribution of rental product which leaves the market open to the smaller players. There is also a substantial second hand market in the rental sector, which allows the smallest independents to access relatively recent titles once larger chains no longer want to stock them in such depth. However, this sector falls outside the remit of this report.

210. The concept of sale or return is not relevant to the rental model at the rentailer level but some wholesalers are understood to benefit from a returns allowance from the studios to ensure that it is not left with unsold rental stock once a title is no longer selling. However, since most rental dealers pre-order their stock even from wholesalers, this is not usually a major consideration.

Premium priced rental product

211. Premium priced rental product is one of two business models in use in the UK rental market, the other being revenue sharing. Traditionally, video rental units were purchased outright and priced at a much higher level

Figure 71: Theatrical-to-DVD window



Source: Screen Digest analysis

than retail units. As a result, stores often could not afford to buy sufficient rental units of the top titles to satisfy customer demand on peak weekend nights, ensuring that many consumers regularly went home without their first choice of title. Over the years average rental prices have declined as studios have implemented a number of systems to increase 'copy depth' (the number of units of each title in stores).

211-1. Today, for a major Studio blockbuster title like *Casino Royale*, a premium priced rental DVD costs around £35 but prices can range from between £25 and £40. However it is important to note that like list prices for retail product, these price points are substantially higher than the actual price paid by retailers, with heavy discounting being commonplace.

212. Screen Digest's revenue and shipment figures for the total rental market indicate that the average price of a rental disc was around £8.50 in 2006, down by close to one tenth on the equivalent figure in 2005 of about £9.25. These prices are inclusive of product supplied on a revenue sharing basis so are lower than the average cost of a premium priced disc, nevertheless the decline in the average price of a rental disc for the total market is indicative of the trend for premium priced rental discs.

213. As a result, although the proportion of turnover retailers typically spend on acquiring stock has not changed fundamentally, rental stores today boast several times as many copies of major titles than they did a few years ago. Meanwhile, the growth of revenue sharing deals means that we estimate that only one in 10 of the total DVD rental units shipped to trade were purchased through the traditional premium priced model. Most rental stores acquiring product this way do so via wholesalers with only a handful of chains buying premium priced product direct from distributors.

Revenue sharing

214. Revenue sharing provides an alternative to the traditional premium priced approach, by allowing retailers to buy rental units for a nominal fee in exchange for splitting the resulting rental revenues with the distributor. The system was virtually unknown in the UK until April 2000, when Blockbuster adopted it and trebled the number of units of top titles on its shelves overnight. Since then several

of the UK's larger rental chains have been able to take advantage of revenue sharing deals. However, the system is only available to companies large enough to have a direct supply relationship with distributors, meaning that smaller independents and chains still have to buy their product from a wholesaler. Furthermore, we understand that some of the UK's smaller chains, despite having direct supply relationships, consider that the revenue sharing terms they have been offered do not make it a viable option. Such is the dominance of the market by the largest rental chains, however, that we believe nine in every 10 new releases shipped to the UK rental market in 2006 were covered by revenue sharing agreements.

215. The exact split of revenues is a highly contentious issue, with our research in the past indicating that it varied from 60:40 in the retailers' favour to 60:40 in favour of the distributor, depending on which party had the balance of power. Today with just the three largest rental chains benefiting from the system in the UK, we believe that instead of a straight split the studios instead receive a guaranteed fee (probably around £1) from each transaction. This approach results in a system much more heavily skewed towards the renter than might be expected, with two thirds of the rental revenue (after costs) being kept by the renter, and one third returned to the distributor.

215-1. The revenue sharing model, for now at least, is exclusive to the offline market. None of the principal providers of online DVD rental in the UK works on this basis, and Screen Digest research indicates there are no plans amongst the principal providers to negotiate such deals. Online DVD rental is less compatible with revenue sharing than its offline counterpart because it uses a subscription model. For pay-per-transaction rental, the value of a transaction is fixed, but for subscription rental this is not possible. It is much more difficult to quantify how much revenue a single transaction has generated within an online DVD rental subscription. That said, there is a precedent for online DVD rental product being supplied on a revenue sharing basis. In the US, Netflix and Blockbuster have revenue sharing deals, and so does Glowria, the market leader in France.

Other video related revenues

Sale of previously viewed titles

216. All rental stores sell on previously viewed titles (PVTs) when a title is no longer new enough to justify retaining a high number of units on the shelves. We have not included revenues from this source in our renter level model since they are not included in industry analyses of consumer spending on rental nor do they have any impact on distributor level revenues.

Late fees

217. Charging consumers when they return a title late can often make a significant contribution to a renter's bottom line. However, since such fees do not have any impact on the flow of revenues between renter and supplier, they have been discounted for the purpose of this analysis.

Video trading

218. The practice of accepting used videos from consumers in return for cash or store credit is gaining in popularity in the UK. However, as with the revenue streams identified above this business, whilst incremental at store level, has no impact on the way in which revenues from consumer spending on rental flow back to the distributor. It has therefore been excluded from this analysis.

Non-video related revenues

219. Many rental dealers have diversified into complementary or indeed completely separate businesses in order to boost their profit margins. Such sidelines can include renting video games, selling confectionary and soft drinks or even offering services such as photo developing or key cutting. As with the video related revenues above, such activities have no impact on the flow of revenues within the video rental sector, and have thus been discounted in this analysis.

4.6.2 Offline DVD rental revenues

220. The traditional 'over-the-counter' DVD rental sector has been characterised in recent years by a volatile market climate. In 2006, the number of rental transactions in the offline sector fell by close to one fifth. Consumer spending (VAT-net) declined accordingly from £321m in 2005 to £289m. That in turn meant that the offline sector's share of total DVD rental spending decreased slightly as the value of the online DVD rental market grew. In 2006, offline rental accounted for 87 per cent of total market revenues compared with 92 per cent in 2005.

220-1. This is not to suggest that the online DVD rental market is cannibalising traditional rental. In fact, our analysis indicates that there is little in the way of a correlation between the decline in offline rental and the growth of its online equivalent – traditional bricks and mortar rental is deteriorating at a far quicker rate than online DVD rental sector. Indeed given that online subscription DVD rental offers such a different consumer experience to 'over-the-counter' DVD rental, it might instead have the potential to expand the pie.

220-2. It is important to note that rental revenues can be adversely affected by a number of factors beyond the renters' control, such as good weather, major sporting tournaments on television, etc. At such times the traditional 'pay as you go' rental model means that revenues collapse. By contrast the subscription rental model, which is used by online rental operators, continues to generate revenues even when transactions are down. There is no reason in theory why this model cannot be adopted by offline business, indeed, in the US, both Blockbuster and Hollywood Video are successfully running such schemes. At the time of writing, however, no UK rental chain was offering this as an alternative. The reason for this is probably that, with a relatively small proportion of the UK public responsible for the bulk of rental transactions, renters fear that such a move would simply allow those high volume renters to pay less, whilst not attracting the less active renters that are needed to make it profitable.

Figure 72: Offline DVD rental – Average price of rental DVD

		2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Average price of rental disc	£	9.36	10.54	11.02	9.46	9.24	8.43	8.30	8.26	8.22	8.18

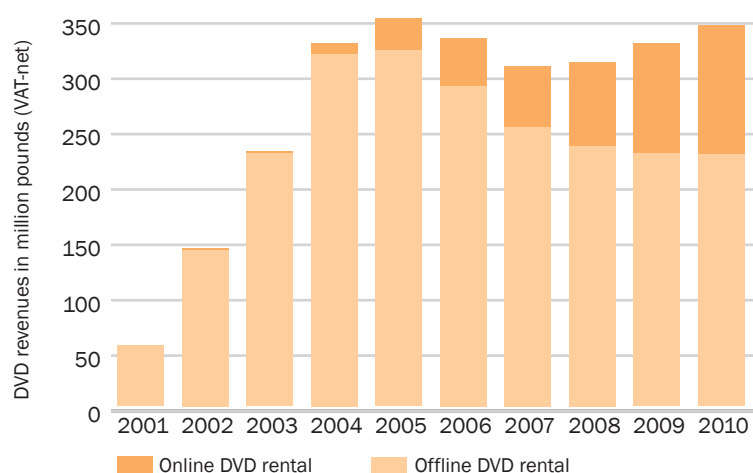
Source: Screen Digest analysis of BVA data

220-3. Historically, the offline video rental market has been based on the à la carte business model, that is to say, pay-per-transaction. There are no high street retailers in the UK offering DVD rental on a subscription basis in-store. It is worth noting though that Blockbuster is effectively doing this in the US so has set a precedent. It has combined its offline and online services in the US in a scheme dubbed Total Access which it launched in November 2006 after a successful trial period. Under the new scheme, US subscribers to Blockbuster's online DVD rental service are able to return their discs to Blockbuster stores. In return they receive a voucher for one free rental in-store. On receipt of the returned disc, Blockbuster mails subscribers the next title on their online request list, unless consumers wish to rent the movie in-store, in which case they must delete the title from their request list to avoid receiving the same title in the mail. Given that product rented in stores under the Total Access programme is the same as the product rented on a traditional pay-per-transaction basis, it is supplied on the same terms. And for Blockbuster, product is supplied on a revenue sharing basis across the board.

220-4. Nevertheless, Blockbuster has made no indication that it plans to introduce the scheme in its UK stores. It could be argued that the fact that the renter has not launched Total Access in the UK is indicative of a lack of long term commitment to the local store-based rental business in general. Indeed, whilst it continues to boast a large footprint in the UK, it closed 23 outlets over 2006, reducing its store count from 915 to 892. This is not to suggest that its focus is on online DVD rental either, with its UK rent-by-post service receiving much lower levels of promotion in the UK than in the US.

220-5. As far as pure, store-based subscription rental goes for the rest of the market, it is unlikely to be adopted. Subscription rental is not really a viable business model for offline retailers, particularly in the current climate. From a consumer perspective, rental has traditionally been a pastime of the lower socio-economic classes, for whom it may be easier to find £3 once a week than to pay £15 in advance at the beginning of the month, whatever the economies of scale involved. And for retailers, the late fees that they can charge in the pay-per-transaction model help cover the overheads of bricks and mortar outlets.

Figure 74: DVD rental - Share of offline vs. online



Source: Screen Digest analysis of BVA data

Figure 73: Offline DVD rental - Share of total DVD rental

		2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Offline DVD rental revenues	£m	55	141	228	318	321	289	252	235	228	227
Offline as % total revenues	%	100	99	99	97	92	87	82	76	70	66
Online DVD rental revenues	£m	-	1	2	10	29	43	55	75	100	117
Online as % total revenues	%	-	1	1	3	8	13	18	24	30	34
Total revenues	£m	55	141	231	328	350	332	307	310	327	344

Source: Screen Digest analysis of BVA data

end of the industry's first boom in the late 1980s. However, for many years this trend reflected the increasing maturity of the sector, as the small independently run outlets that had dominated it in the early days gave way to increasingly professional chains. As a result the market is now dominated by a handful of key chains, which tend to operate larger stores.

Blockbuster

223. US rental giant Blockbuster dominates the offline DVD market, accounting for 48 per cent of transactions in 2006 according to TNS Audio Visual Trak. It also boasts the highest store count of the offline rental players at 695. Blockbuster UK is a fully-owned division of

Blockbuster Inc which was spun off from former parent Viacom in October 2004. The company has long been positioning itself as more than a video rental chain, expanding into video retailing, video games sales and rentals and in-store 'trading' of used retail DVDs in stores. Blockbuster has also been involved in the online DVD rental sector in the UK since May 2004 (see section 4.7 for more information).

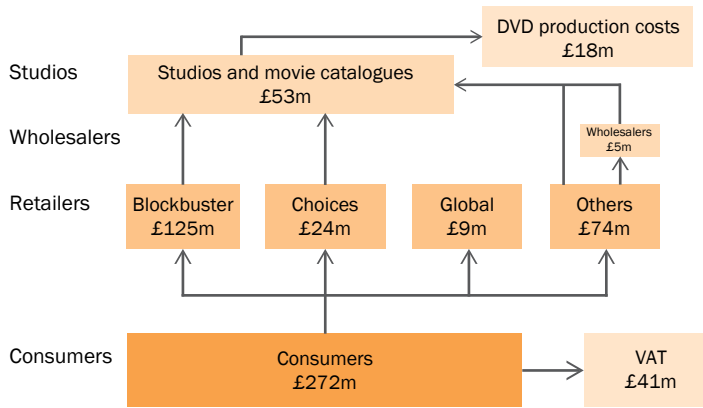
Choices

224. According to TNS Audio Visual Trak, Choices was the next largest off-line DVD renter in 2006, accounting for 11 per cent of transactions in the UK that year. Choices went into administration in August 2007, closing more than 30 of its most unprofitable stores. At the time of writing a deal to sell-off its remaining 139 high street sites was yet to be finalised.

Global Video

225. Global Video was the third largest offline DVD renter in 2006. With 192 stores it had a smaller footprint than Blockbuster and Choices; this was reflected in its share of the offline DVD rental market which at five per cent was smaller than the other two principal providers. Like Choices, Global Video's business suffered in an increasingly tough

Figure 76: Offline DVD rental – Cash Flow Chain (2006)



Source: Screen Digest analysis of BVA/TNS data

Figure 75: Offline DVD rental – Total market by renter

		2001	2002	2003	2004	2005	2006
Blockbuster	%	29	33	40	43	37	36
Global	%	8	7	7	6	5	4
Choices	%	8	8	8	9	8	8
Apollo	%	6					
Independent rental specialists	%		20	17	17	15	12
Other video chains	%	34	10	8	5	4	3
Convenience store	%	12	9	8	7	6	5
Newsagent	%		2	2	2	1	1
Public Library	%	3				5	7
Other offline	%	4	12	10	9	9	1
Total offline	%	100	100	100	96	88	76
LoveFilm	%						18
Blockbuster online	%						2
Other online	%				4	12	4
Total online	%	0	0	0	4	12	24

Notes: 1. Based on transactions for all DVD

Source: Screen Digest analysis of BVA/TNS data

rental climate and in June 2007, the company entered administration.

4.7 Online DVD rental

4.7.1 Online DVD rental revenues

226. Subscription DVD rent-by-post, also known as 'rentmail', was pioneered by Netflix in the US in 1997. This sector is now flourishing in the UK, with the rental

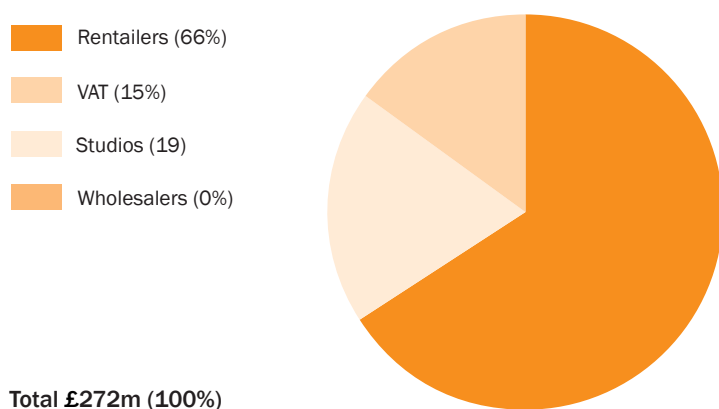
of movies through such services generating £43m (VAT-net) in 2006, about one and a half times as much as in 2005 (see figure 58). Over the same period DVD rentmail's share of all DVD rental spending rose from 8 per cent in 2005 to 13 per cent whilst its contribution to the DVD market (retail and rental) as a whole climbed from two per cent to three per cent. The rapid growth of the sector reflects that the DVD format was in the ascendancy in the rental market. The online sector is an exclusively DVD-based business, functioning thanks to the format's compact size which makes it fit for mailing.

227. Unlike their offline counterparts, online rentailers can generally count on only one revenue stream: the money their consumers pay to rent DVDs. However, since they all operate on a subscription basis, this income is more stable than that of the offline rental store, which tends to be adversely affected by factors beyond the rentailers' control.

4.7.2 Cashflow chain and margins

228. In 2006 UK consumers spent £50m on movies through online DVD rental (approximately £43m after VAT is deducted). The principal providers, LoveFilm and

Figure 77: Offline DVD rental – Share of gross revenue



Source: Screen Digest analysis of BVA/TNS data

Figure 78: Offline DVD rental - Store count

	1990	1991	1992	1993	1994	1995	1996	1997
Rental stores	9,000	7,800	7,600	6,500	5,673	5,200	4,860	4,500
	1998	1999	2000	2001	2002	2003	2004	2005
Rental stores	4,175	3,900	3,750	3,700	3,485	3,307	3,157	3,077

Source: TNS

Figure 79: Offline DVD retail - Market share by rentailer

Retailer	Share of offline DVD retail (%)	Share of total DVD retail (%)
Blockbuster	48	36
Global	5	4
Choices	11	8
Independent rental specialists	15	12
Other video chains	3	3
Convenience store	6	5
Newsagent	2	1
Public Library	9	7
Other offline	1	1
Total offline	100	76

Notes: 1. Based on 2006 transactions for all DVD

Source: TNS

Blockbuster, accounted for £37m of revenues, giving them a combined market share of 86 per cent.

229. According to our analysis, studios share of gross revenues was around eight per cent, with retailers securing just over half. The ancillary cost of postage represented over a quarter of gross revenues.

4.7.3 Online rental environment

230. The principal costs involved in running an online video rental business are acquiring inventory and postage.

Acquiring inventory

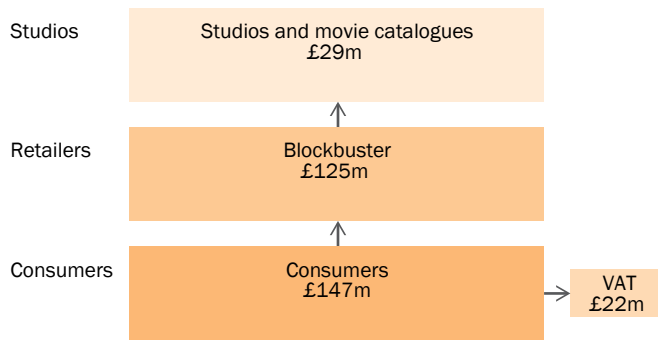
231. Like their offline counterparts, online rentailers also have to buy new titles on a regular basis. However, unlike offline rentailers their stock acquisition is not limited to the traditional profile of a rental title (i.e. movies). One of the features of subscription rental (which is an exclusively online domain in the UK at the time of writing) is that consumers rent a much broader range of titles, including not only catalogue movies, but also TV DVD, children's, sports and documentaries.

232. Thus, even the UK's leading online rental operators buy far fewer new titles designated 'for rental' than a rental chain generating a similar number of rental transactions would. On the other hand, however, they also have to buy copies of many of the numerous 'for retail' titles that are released in the UK each month. In the US, Netflix has claimed that 98 per cent of its inventory is rented every month, meaning that even if an online operator buys some these titles on a 'just in time' basis (i.e., only acquiring them when they know there is customer demand), it cannot get away with claiming titles which it does not have.

233. Our model assumes that although the online rental sector generated 28m transactions in 2006, 75 per cent of these (21m) were feature films and new releases accounted for 25 per cent of film rentals. The proportion of new releases purchased and thus available for rental varies significantly between companies. Our research indicates Blockbuster buys in a greater proportion of new release rental titles than LoveFilm.

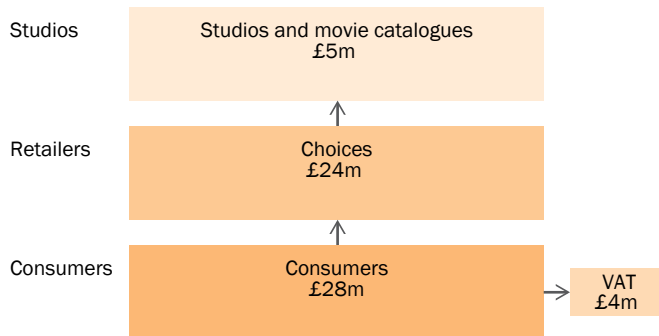
234. It is our understanding that no revenue sharing deals have officially been struck between studios and online rental operators (for more information see Revenue Sharing in section 4.6.1 Rental environment). Our research indicates that in 2006 online rental operators in the UK spent £3m on buying premium priced rental DVDs. In addition, we believe they spent £1m on buying retail priced DVDs for rental. It should be noted that we have assumed that the online operators

Figure 80: Offline DVD rental - Blockbuster in the value chain



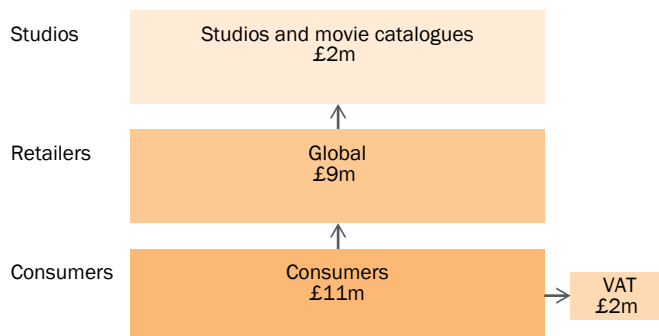
Source: Screen Digest analysis of BVA/TNS data

Figure 81: Offline DVD rental - Choices in the value chain



Source: Screen Digest analysis of BVA/TNS data

Figure 82: Offline DVD rental - Global in the value chain



Source: Screen Digest analysis of BVA/TNS data

identified in this report had cleared any such rentals with the rightsholders concerned.

Postage

235. All online rental offers include 'free' postage and packing to the consumer, meaning that these costs must be absorbed by the company. Standard UK first class postage (which is sufficient for a single DVD) costs 32 pence. As regular users of the service, the online rental companies benefit from business rates, resulting in total postage costs per transaction (outward and return) of around 60 pence.

236. Thus the 21m feature film rental transactions made through online operators in 2006 generated further costs of £13m in postage, reducing the net revenues of this sector to just over £30m.

4.7.4 Principal Providers

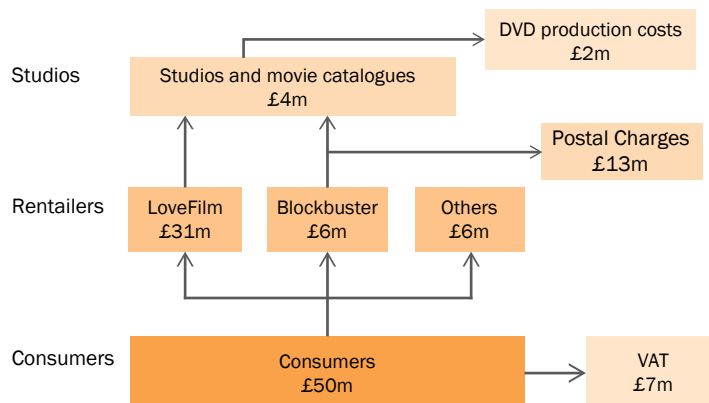
237. Whilst the traditional offline rental market has showed little or no growth in recent years, the UK has seen an explosion in the number of online rental operators. The first online rental service was launched in the UK in 1999 by MovieTrak, but it was not until mid 2001 that the first UK website (in-movies.co.uk) began offering a subscription model similar to the one which had already proved so successful for Netflix in the US. By Q2 2004 over 20 companies, both Internet start-ups and online divisions of existing brick-and-mortar chains were competing in the crowded UK online rental sector. The inevitable process of consolidation began in late 2003 and by the end of 2006 two services had emerged as the sector's key players.

LoveFilm

238. LoveFilm launched in May 2002 under the name DVDs On Tap. It merged with Video Island - owner of rival service ScreenSelect - in Q1 2006. Both partners hold an equal share in the deal which has given the combined group more than 400,000 subscribers and a market share of 75 per cent based on 2006 data. The move was designed to consolidate the companies' position in the online DVD rental sector, to accelerate profits, and also expansion through European territories. LoveFilm has already established services in the Scandinavian market, with operations in Sweden, Denmark and Norway.

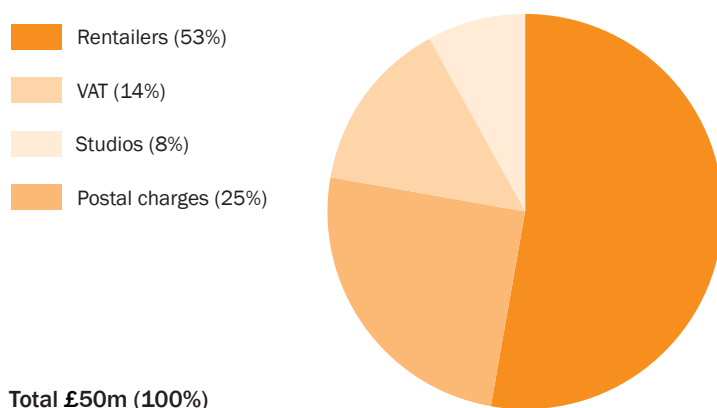
239. The merged company, which opted to retain the LoveFilm brand, holds around 70,000 different titles and a stock of 1.2m DVDs and video games. Combined, the two companies portfolios include AOL, CD Wow, Channel 4, Dixons Store Group, easyGroup, Guardian Newspapers, ITV, MSN, News International, Odeon, Sainsbury, Tesco and Vue cinemas, some of whom offer a fully white-labelled service. The new investor base for the group will include Arts Alliance Media (AAM), the majority shareholder in LoveFilm, and Video Island's financial backers Benchmark Capital, Index Ventures, Cazenove Private Equity and European Venture Partners. In November 2005 LoveFilm launched a movie downloading service (see LoveFilm profile in Internet-based rental and retail section) alongside its DVD and games rentmail offerings as part of its bid to position itself as a one-stop-shop for entertainment.

Figure 84: Online DVD rental – Cash Flow Chain (2006)



Source: Screen Digest analysis of BVA/TNS data

Figure 83: Online DVD rental – Share of gross revenue



Source: Screen Digest analysis of BVA/TNS data

Blockbuster

240. Consumer awareness of the online rental sector was boosted in May 2004 when leading offline rentailer Blockbuster launched its own online subscription model (it had already been offering online pay-as-you-go rental for some time). In addition to intensifying the competition, the entry of such a high profile brand significantly raised the profile of the sector. In late 2003 online rental pioneer Netflix had announced its intentions to expand into the UK market during 2004, a fact that intensified pressure on the incumbent UK players to consolidate their positions. In the end, in the face of intense competition and shareholder concern in its domestic market, Netflix abandoned its planned UK launch in late 2004, at a cost of \$3m in operating and disengagement costs.

241. Blockbuster was the second largest player in the online DVD rental market in 2006, accounting for nine per cent of online rental volume, but is undoubtedly the dominant rentailer in the overall market. Combined, Blockbuster's offline and online DVD rental businesses give it a 39 per cent share of all DVD rental transactions. In the US it has actually combined its offline and online services in a scheme dubbed Total Access which it launched in November 2006 after a successful trial period. Under the new scheme, US subscribers to Blockbuster's online DVD rental service are able to return their discs to Blockbuster stores. In return they receive a voucher for one free rental in-store. On receipt of the returned disc, Blockbuster mails subscribers the next title on their online request list, unless consumers wish to rent the movie in-store, in which case they must delete the title from their request list to avoid receiving the same title in the mail. The strategy is one that its chief competitor in the US online space, pure online player Netflix, cannot rival making Blockbuster's offline-online hybrid business model something of a

unique selling point (USP). The same would be true in the UK if it opted to launch a local service.

4.8 DVD rental - Market-specific issues

New release v. catalogue

242. The offline rental business revolves around new releases. Within this sector, catalogue titles account for a relatively small proportion of business, assumed in our model to be between 10 and 15 per cent. Since the initial cost of a rental title, whether acquired under the traditional or revenue sharing system, is fully amortised by the time a title becomes catalogue, such revenues are assumed in our model to represent additional profit for the rental store and to have no impact on the distributor's bottom line.

243. Unlike the traditional rental model, a significant portion of the online rental business is generated by catalogue product. Since most online operators are relatively new companies, and since one of the features they use to distinguish themselves from the competition is inventory size, they have had to acquire a vast number of titles in a short time. At this stage in the business, however, we believe that all the established players have established libraries and we have therefore assumed that their inventory costs are restricted to new releases and expansion of catalogue titles to meet the demands of expanding subscriber bases.

The long tail

244. The arrival of subscription DVD-by-post services has transformed the rental market. Historically a new release business, rental is now generating value from catalogue product, independent titles and niche product thanks to the online sector. And whilst this report is

Figure 85: Online DVD rental - Market shares by rentailer

Retailer	Share of offline DVD retail (%)	Share of total DVD retail (%)
LoveFilm	72	18
Blockbuster online	13	2
Other online	15	4
Total online	100	24

Note: Based on 2006 transactions for all DVD

Source: Screen Digest analysis of BVA/TNS data

concerned with film only, it is worth noting that online DVD rental has also encouraged growth in the rental of non-feature titles, particularly TV DVD.

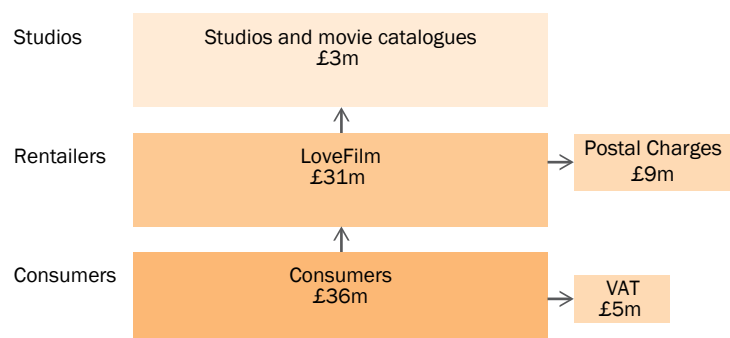
245. Like etailers, the rentmail players have an advantage over their bricks and mortar equivalents in that they can offer a much larger library of titles as they have no shelf space or shop floor capacity to consider. It is not feasible to employ the long tail strategy in a rental store stocking no more than around 1,000 titles, but for the likes of LoveFilm, which boasts some 40,000 titles, it is a viable business model.

246. Indeed, rental transactions for the online services are more broadly distributed than they are in the offline environment. This is borne out by our analysis of the top 30 titles in the respective rental markets. For offline rental, the top 30 titles accounted for just over one fifth of all transactions, whereas the top 30 generated just 10 per cent of total transactions in the online space.

Release windows

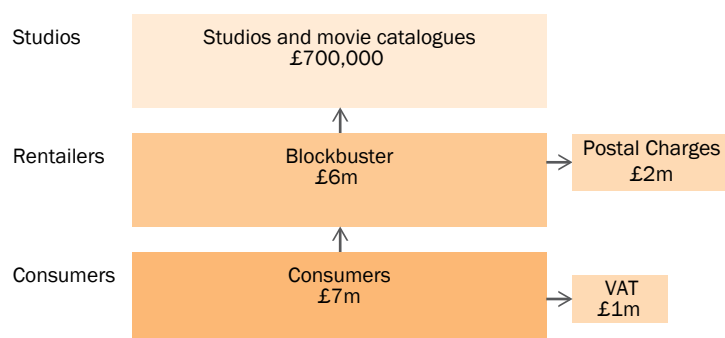
247. Video rental is no longer assigned its own window, instead titles are released for rental day and date with their retail release. Historically, titles were available for rental about six months after their theatrical debut and up to six months before they were released for retail. However, following the launch of DVD and the explosion in retail spending, distributors opted to forgo an exclusive rental window and to bring the retail window and its huge revenues forward. Between mid 2002 and late 2003, all the major Studios effectively abolished the rental window and began releasing titles for retail and rental simultaneously. Initially, this provoked a backlash from rentailers, who considered the higher prices that they paid distributors for rental product to be a trade-off for a ring-fenced period of exploitation. Nonetheless, distributors weathered the storm, and in most cases titles are now released to both rental and retail DVD simultaneously. There are occasionally exceptions to the rule, mostly independent titles, where distributors will impose a rental window in an effort to squeeze maximum revenues from rental before releasing it for retail but this strategy is evidently not especially fruitful as few choose to adopt it.

Figure 86: Online DVD rental - LoveFilm in the value chain



Source: Screen Digest analysis of BVA/TNS data

Figure 87: Online DVD rental - Blockbuster in the value chain



Source: Screen Digest analysis of BVA/TNS data

4.9 Looking ahead

248. The UK DVD market has matured, albeit to a slightly lesser degree in the online markets than offline. Overall though, we believe that the growth that has defined the format in recent years has now plateaued. This assessment takes into account the impact of the new hi-def disc formats Blu-ray Disc and HD-DVD which are expected to provide only moderate growth for movies in the forecast period (see Hi-def section for more information).

249. On the retail side, whilst we expect the new high definition formats to augment volume sales at consumer level, we believe that growth will be modest as we do not expect consumers to repurchase their existing DVD libraries. Instead, we anticipate that they will 'cherry-pick'; buying key new releases and their favourite catalogue titles on hi-def. Providing distributors and retailers maintain a premium price point for hi-def product, the formats should, however, help raise average prices, boosting spending more than volume sales.

250. We expect this to be apparent at trade level as well. Distributors are likely to continue to charge higher prices for hi-def units, not only to boost their revenues but to off-set the increased cost of producing the software. Nonetheless, the hi-def formats should help maintain retailers' margin thanks to accordingly high consumer prices. Indeed, if retailers opt not to discount hi-def discs as aggressively as they currently do DVDs, the new formats could also help restore margins. Experience suggests, however, that this is probably unlikely.

251. With regards the format war, most observers have assumed that it is inevitable that a clear victor will emerge, just as VHS triumphed over Betamax. However, Screen Digest does not share this view: instead, we believe that the most likely outcome, based on the current status quo, is that both formats will co-exist for some time to come, with an increasing number of the currently partisan hardware manufacturers and Studios moving to a 'format agnostic' position and supporting them both.

252. In the context of the retail environment and the principal providers assessed in this section, the arrival of hi-def disc could expand the audio-visual specialist's share of the offline market. Conversely, depending on how quick they are to stock the new formats, it may slow the supermarkets' march on the sector. The online retailers are arguably at an advantage in the current situation, given their ability to stock an infinite inventory. Retailers could conceivably have to stock three different versions of a title (DVD, HD DVD and Blu-ray), and for bricks and mortar stores - where shelf space is already under pressure - this could represent a predicament.

253. We contend that the rental market will continue to decline over the forecast period but at a slower rate than before because we expect rental to be considered an attractive interim solution for consumers concerned about investing in the 'wrong' hi-def format. However, we do not anticipate that the launch of HD DVD and Blu-ray will stimulate the rental market to the same degree that they will the retail sector.

254. As with the retail sector, the online players in the rental space have an advantage over the offline retailers in that they are better equipped to cater for a multi-format

market. We expect this to accelerate the expansion of the rentmail sector's market share over the forecast period. By 2010, we expect that online services will account for around three quarters of the rental business.

5 TV-based VOD

5.1 Key findings

- **Definition:** 'TV-based' or 'Walled-Garden' VOD services (as opposed to Internet-based VOD) can be broken down into nVOD services (Sky) and true-VOD services (IPTV since 2000 and cable since 2005).
- **Enabled homes:** today, 11m UK households can access one of the two. By 2011, this figure will have risen to almost 15m.
- **Consumption levels:** average buy rates are much higher with true VOD (7 titles a year versus 1.5 on traditional nVOD).
- **Window and terms:** the PPV/VOD window opens as early as six months after theatrical release. All VOD operators can access all studio catalogues on a non-exclusive basis.
- **Value Chain:** FilmFlex is an important 'middle-man' in this particular market, managing the back-end for cable, and negotiating rights deals with all US Studios (except in the case of Sky which is dealing directly with Studios).
- **Consumer spending:** of the £248m (VAT-net) spent by UK consumers on VOD in 2006, £83m was spent on movie transactions (£78m on new releases). In 2011 we expect total VOD spending to reach £555m, with VOD movie spending growing to £168m (£145m on recent new releases). However, we expect buy-rates and growth to be offset by competition from Internet VOD from 2008-2009.
- **Principal providers:** BSkyB and Virgin Media (98 per cent combined market share) currently represent a virtual duopoly in the VOD market. Other players (BT Vision and Tiscali TV) are likely to capture up to 20 per cent market share by 2011.
- **Studio revenues:** we estimate that movie rights-holders received approximately 50 per cent of the net consumer revenue, e.g. about £40m in 2006.

5.2 Introduction

255. In this section we analyse TV-based 'on demand' movie services. They are sometimes also referred to as 'set-top box based' video on demand or 'Walled Garden' VOD services.

256. In this section we do not look at open gateway Internet-based VOD (e.g. Sky Anytime on PC) services, also known as Internet-based VOD, although movies downloaded through a PC can then be viewed

on the TV set if suitable connections are made. Internet VOD is addressed in a separate section of this report.

257. TV-based VOD and Internet VOD share characteristics in terms of windows and are increasingly competitive services, but we choose to address them separately for the following reasons:

- whilst there is some crossover, service providers largely differ across the sectors

- and come from different segments of the audiovisual industry
- the market for TV-based VOD is maturing but Internet VOD is in its infancy.

258. On demand television is the delivery of TV content on request. Content is usually selected from a menu of available material and viewed one or more times within a period of time.

259. By pay-per-view (PPV) Screen Digest prefers to refer to a transactional business model used for on-demand television services, irrespective of the technical platform, where a charge is made for each piece of content viewed.

260. 'PPV' also sometimes refers to the early incarnations of on demand TV services in the US when consumers had to make a phone call to reserve and pay in advance for a upcoming programme (movie, sport event). That early form of on demand service was introduced by BSkyB in the UK in January 1997 (four PPV movie channels).

261-1. nVOD stands for near Video-on-Demand and refers to an on-demand television system in which multiple channels are used to show the same piece of content at staggered start times. The gap between each available viewing time is a factor of the number of channels dedicated to the service and the amount of content on offer, but would commonly be 15 minutes or half an hour. In contrast to the early 'PPV' services described above, nVOD can be referred to as 'impulse PPV'. Contrary to the old model, a programme can be selected by simply browsing a menu with the remote control.

261-2. nVOD systems are used by satellite pay television operators like BSkyB which lack the one-to-one network architecture and broadband back-channel that allow 'true

VOD'. nVOD was introduced by Sky Digital in October 1998.

262. Push Video-on-Demand is a technique using a combination of nVOD and set-top boxes featuring Personal Video Recorder (PVR) capability like 'Sky Anytime On TV' or 'Top Up TV Anytime' on DTT. Content is 'pushed' beforehand (e.g. during the night) and stored on a specially partitioned part of the PVR so that the consumer can enjoy 'true-VOD-like' service (with no delay) but on a limited number of titles, depending of the capacity of the hard drive PVR.

263. 'True' Video-on-Demand (VOD), as opposed to nVOD, refers to an on-demand television system which stores content on a server and then streams in real time to the viewer. VOD systems allow the customer to enjoy impulse pay-per-view, start viewing the content at any time, as well as to pause and rewind the content, like on a DVD. It involves a 'unicast' one-to-one architecture, as opposed to the 'broadcast' model of satellite-based nVOD.

264. In terms of business models, on demand services can be based:

- on a purely transactional model (PPV)
- on a flat subscription basis giving access to unlimited viewing
- on a free basis for all existing digital TV subscribers
- on a combination of these.

264-1. Whatever the form and window of the service, movie rights are almost always granted on a non-exclusive basis.

5.3 Market data and revenues

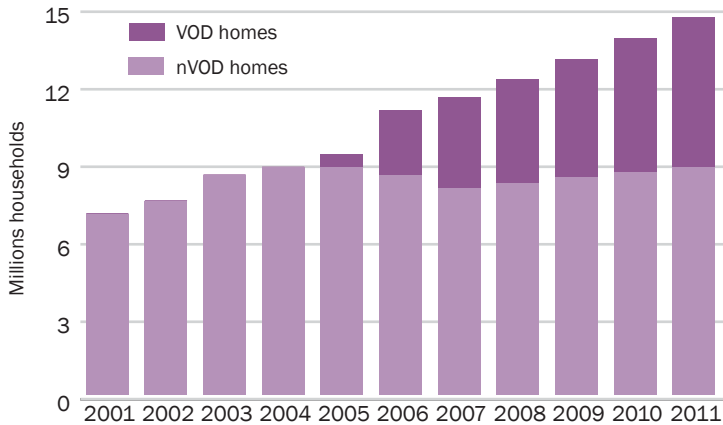
5.3.1 Enabled VOD homes

265. At the end of 2006, around 11m UK households were technically able to use VOD or nVOD, and therefore form the addressable

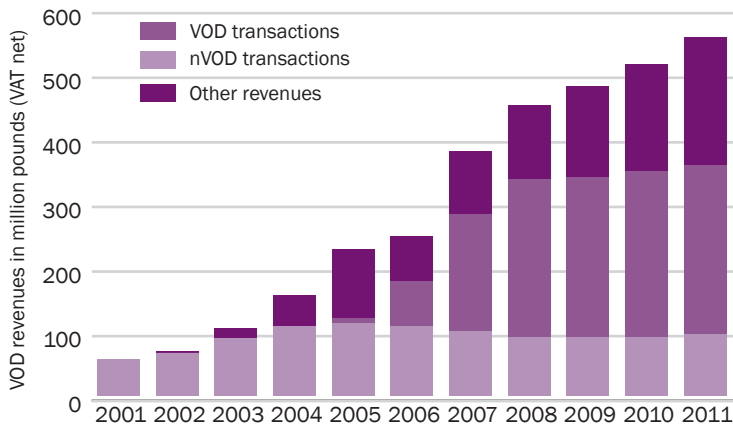
Figure 88: TV-based VOD – History and availability

	Phone-based 'PPV'	Impulse PPV (nVOD)	(True) VOD
Introduction	USA 70s Sky 1997 Cable 1998	Sky October 1998 Cable November 1999	Kingston 1999, Homechoice 2000, Digital Cable 2005
Today	-	BSkyB, FrontRow on cable (being phased out)	Tiscali Homechoice, Virgin Media, BT Vision

Source: Screen Digest

Figure 90: TV-based VOD – Enabled households

Source: Screen Digest

Figure 92: TV-based VOD – Revenues by platform (incl. non-film)

Source: Screen Digest

market for on demand services. Back in 2001, there were only 7m, and most of them on nVOD through BSkyB. In the early 2000s, it is estimated that about 75 per cent of Sky subscribers had 'plugged in' their set-top boxes to a phone line and activated the return-path so that they could access impulse nVOD. This ratio is growing slowly but we still anticipate that a proportion of Sky subscribers will never activate the return path because they are simply not interested in interactive services and VOD.

266. True VOD was launched by IPTV operator Homechoice in 2000 but the real take-up happened early 2005 when Telewest and NTL both launched their VOD over cable services (both operated by FilmFlex). At the end 2006, Screen Digest estimated that 2.5m UK households could access true VOD on cable and IPTV.

267. By the end of 2011 the number of enabled households to reach 14.6m (55 per cent of all UK households). The proportion of nVoD-enabled homes (8.7m) within this bracket is expected to stagnate, and all digital cable subscribers will be migrated to true VOD.

5.3.2 Total TV VOD revenues

268. We estimate that revenues from TV-VOD services in the UK in 2006 totalled £248m. Movie transaction revenues (pay-per-view payments) for nVOD and VOD represented roughly 60:40, and £70m came from indirect

Figure 89: TV-based VOD – Enabled households

million HH	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
nVOD	7.0	7.5	8.5	8.8	8.8	8.5	8.0	8.2	8.4	8.6	8.8
VOD	0.0	0.0	0.0	0.0	0.5	2.5	3.5	4.0	4.6	5.2	5.8
Total	7.0	7.5	8.5	8.8	9.2	11.0	11.5	12.2	13.0	13.8	14.6

Source: Screen Digest

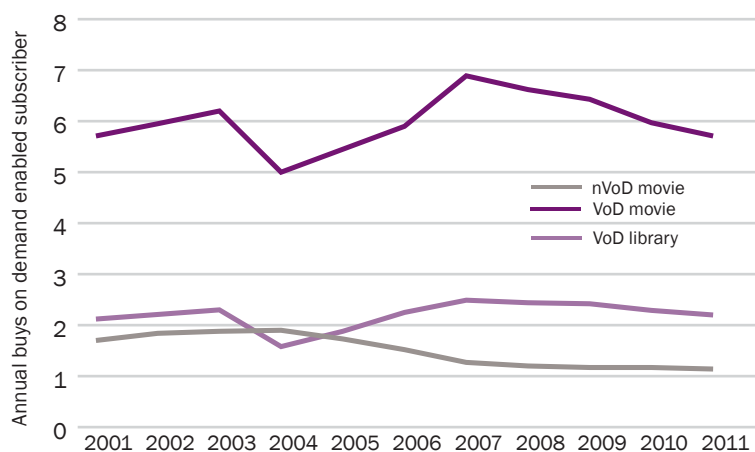
Figure 91: TV-based VOD – Revenues by platform (incl. non-film)

£m	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
nVOD subtotal	56	66	89	107	112	108	100	91	90	91	95
VOD subtotal	0	0	0	0	9	69	182	244	249	256	263
Other ind. revenues	1	4	16	49	106	70	97	115	140	167	197
Total	57	70	106	156	227	248	378	450	478	513	555
Growth		23%	51%	48%	45%	9%	53%	19%	6%	7%	8%
Growth transactions		18%	36%	20%	13%	47%	59%	19%	1%	2%	3%

Source: Screen Digest

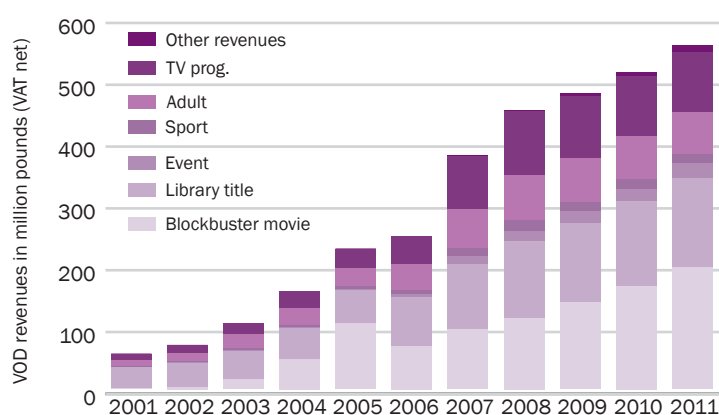
non-transactional revenues (subscription, set-top box rental fee). The latter revenues decreased significantly compared with 2005 when they totalled £100m because Sky stopped charging a PVR rental fee for its premium package customers.

Figure 95: TV-based VOD – Buy Rates



Source: Screen Digest

Figure 94: TV-based VOD – Revenues by content type



Source: Screen Digest

Figure 93: TV-based VOD – Revenues by content type

£m	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
blockbuster movie	34	38	46	50	55	78	106	124	129	137	145
library title	0	1	1	1	1	5	12	17	18	20	23
event	2	2	3	4	5	8	14	17	16	16	15
sport	10	14	23	26	29	41	62	74	71	69	68
adult	10	12	17	28	31	45	86	102	99	97	97
TV prog.	0	0	0	0	0	0	1	2	5	7	11
total transactions	56	66	90	107	121	177	281	335	338	347	358
other revenues	1	4	16	49	106	70	97	115	140	167	197
total	57	70	106	156	227	248	378	450	478	513	555

Source: Screen Digest

269. After double-figure growth rates in the early 2000s, TV-VOD revenues plateaued in 2004-2005. Market growth is accelerating again now because the addressable market (digital TT subscribers) has increased and, more importantly, because the average buy-rate is higher following the introduction true VOD.

270. We expect revenue growth to accelerate to 59 per cent growth in 2007 due to true VOD but then total TV-based VOD revenues will plateau again after 2008 for several reasons:

- once the novelty 'wow' factor has passed, the true-VOD buy-rate will stabilise and go back its traditionally low level
- by 2008-2009 TV-based VOD operators will face the full force of competition of online VOD (and most of them will also offer such services)
- the subscription VoD model will become more established. Most archive TV programmes are likely to be accessed through an SVoD service, thereby detracting consumer attention from transactional VoD.

5.3.3 Focus on movie VOD

271. Of the £248m spent on VOD in 2006, about £83m was spent on movie transactions (excluding adult movies). Around £78m of movie spending was on blockbusters and £5m on catalogue titles.

272. The 'other VOD revenues' noted below include PVR fees (introduced by Sky+ in 2005 and then stopped), access fees, and sVOD (for TV programmes)—the latter launched in 2006.

5.3.4 VOD consumption – buy rates

273. nVOD buy rates are predicted to suffer a slow decline as Virgin Media phases out its nVOD service and the limited range of films on Sky causes its Sky Box Office transactions to wane. Following the transient dip caused by the introduction of true VOD in 2005 by cable, VOD buy rates will gradually increase, until online services become popular enough

to compete with TV-based on demand services—we predict this will happen in 2008.

274. According to our modelling, VOD-enabled households buy—on average—7.5 titles per year, of which about 5.5 are new releases and two are library titles.

5.4 Cashflow chain and margins

275. In 2006, gross consumer spending of £100m on movie VOD services translated into net revenues of £83m, of which Virgin Media made about 42 per cent and Sky 56 per cent. According to our estimates, FilmFlex received about £24m of the £35m received by Virgin Media. Sky is not using FilmFlex as a ‘middle man’ and is dealing directly with Studios, as is BT.

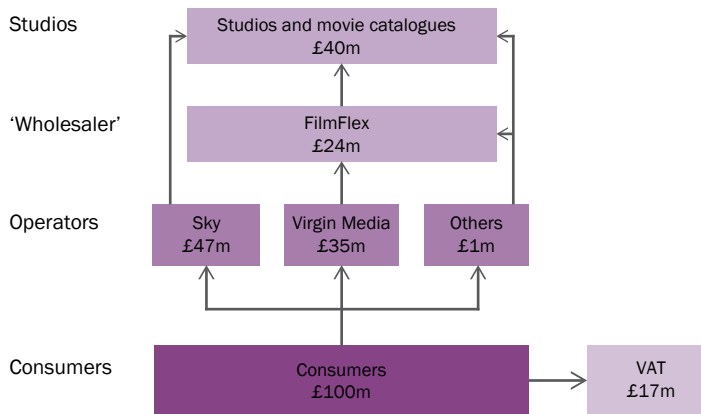
276. Overall, applying revenue sharing assumptions, movie studios received an estimated £40m from the exploitation, or 50 per cent of net revenues. This translates into about 41 per cent of gross consumer spending.

5.5 Principal providers

277. Virgin Media and BSkyB currently hold around 98 per cent of the nation’s on demand market, with newcomers Tiscali and BT having a combined market share of less than two per cent. In terms of true VOD, Virgin Media is generating over 95 per cent of the UK revenues.

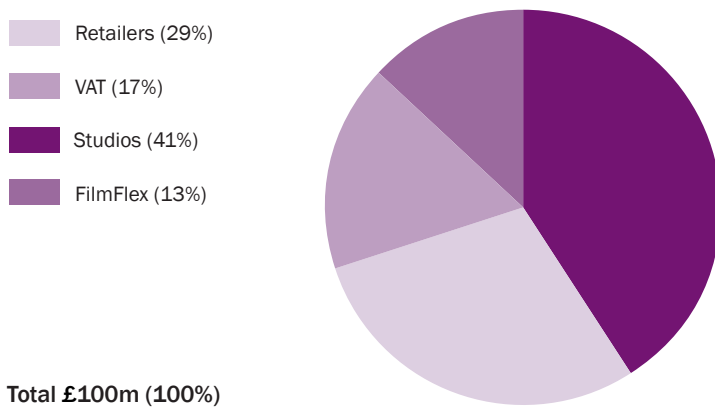
278. This situation is likely to change over the next four years, with true VOD expected to allow BT and Tiscali to secure larger shares of the market. By 2010, BT and Tiscali are predicted to have a combined market share of almost 25 per cent. Likewise, on-demand

Figure 97: TV-based VOD – Movie Cash Flow Chain (2006)



Source: Screen Digest analysis of BVA/TNS data

Figure 96: TV-based VOD – Share of gross revenue



Source: Screen Digest

Figure 98: TV-based VOD – Providers Market Shares

	Type	Ownership	Enabled homes 2006	Movie revenues (£m, 2006)	Market share
Virgin Media	nVOD +VOD	Virgin (10.5%), financial investors	2.4m VOD, 0.93m nVOD	35.1	42%
Sky	nVOD	News Corp. (39%)	7.5m nVOD	46.6	56%
Tiscali TV	VOD	Tiscali	49,000	1.0	1%
BT Vision	VOD	BT	4,000	0.023	0%
Total			10.9m	83.1	100%

Source: Screen Digest

revenues for Virgin Media are predicted to outstrip those of Sky this year following massive growth in Virgin's true VOD segment.

279. From 2008 onwards however, an increase in the supply of and demand for Internet VOD services will erode the revenues of VoD service providers. Overall, revenues will continue to grow, buoyed by subscriber additions to the new IPTV platforms, however, cable revenues will decline, being the slowest growing platform of the three. Sky will see on-demand ARPUs drop, but revenues stabilised by high levels of additions to the platform; little to no revenue growth will be observed.

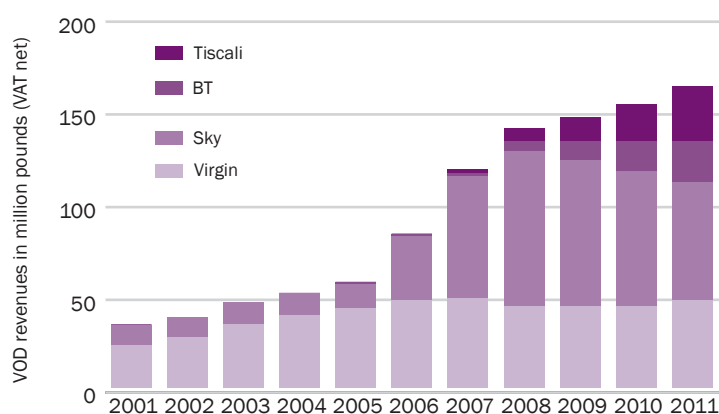
280. With moderate growth in subscriber base predicted and a range of SVOD services (kids, C4 catch-up but not movie SVOD), BT is expected to experience a rapid increase in revenues from a standing start. Likewise, Tiscali, with its own variety of on demand services will see revenues climb. However, due to its marketing model of predominantly 'free' on-demand content, the majority of this revenue will be through movie rentals.

Virgin Media: Virgin Central

281. Virgin Media was the first operator to launch VOD nationally, under the current brand Virgin Central. Although Virgin offers less library movies at any one time than its IPTV competitors (about 500 v. 1,000), it is currently the only platform with high definition on-demand content. Over the next few years, this could prove to be a key differentiator, as IPTV services currently lack the bandwidth to offer anything more than push-VoD HD services.

282. The lack of subscription on-demand content, however, while currently lucrative for the operator, is likely to cause it some problems from 2008, as customers begin to take their on-demand content from other, potentially cheaper sources.

Figure 100: TV-based VOD – Movie revenues (2001-2011)



Source: Screen Digest

Figure 99: TV-based VOD – Movie revenues (2001-2011)

£m	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Sky	23	27	34	39	43	47	48	44	44	44	47
Virgin	11	11	12	12	13	35	66	84	79	73	64
Tiscali	0	0	0	0	1	1	2	5	10	16	22
BT	0	0	0	0	0	0	2	7	13	20	30
Total	34	38	47	50	57	83	118	139	145	153	162

Source: Screen Digest

Figure 101: TV-based VOD – Virgin offering

package	content	pricing
movie (recent and cult classics)	500 movies	£1.50 to £3.75
HD movies (recent only)	Around 25 (10 at any moment)	£4 to £4.50
TV choice on demand	Popular series	SVOD £5 a month
catch up TV	7 day TV selection	Free
music videos	1000 (clips and concerts)	From £0.20

Source: Screen Digest from Virgin website

283. Virgin Media is outsourcing its VOD operations to FilmFlex (see this player's profile below). Through FilmFlex rights management, Virgin can offer blockbusters and library movie catalogues from all Hollywood Studios and a number of independent producers.

BSkyB: Sky Box Office

284. BSkyB has ongoing PPV deals with all US Studios through direct negotiation which takes place at the same time as Pay-TV window rights. Whether they are included in the same contracts and on what terms may vary from contract to contract. BSkyB is unlikely not to use some titles from PPV offering in order to strengthen them on the following Premium pay subscription window. All major films are offered on demand and then on Sky Premium movie channels.

284.1. BSkyB, having enjoyed dominance in the PPV market for the best part of a decade, is now being challenged by operators using digital cable and IPTV to offer true VOD. Lacking the ability to offer a true VOD experience, and with prices typically higher than its rivals, declining buy-rates will slow down Sky Box Office's revenue growth. However BSkyB's strong subscriber additions will go some way to counteract the decline in

transactions faced by the company over the next four years.

285. In 2006, BSkyB launched an Internet-based VOD service called 'Sky Anytime on PC' (see Internet-VOD section for details). This year (2007) BSkyB launched 'Sky Anytime on PC' as a PVR-based push-VOD service. The service comes free for subscribers who upgrade to the PVR or PVR-HD boxes, although content is limited by the packages the subscriber takes. The movies (and other selected TV programmes) are 'pushed' to the box after their first transmission on Sky channels, creating a 'catch-up' service. The capacity to watch the programmes and movies depends upon the subscriber's tier: for instance only Premium movie subscribers will be able to watch the films from Sky Movies pushed to their PVR box. The in-house competition from these new Sky services is factored into our forecast of declining nVOD buy-rates.

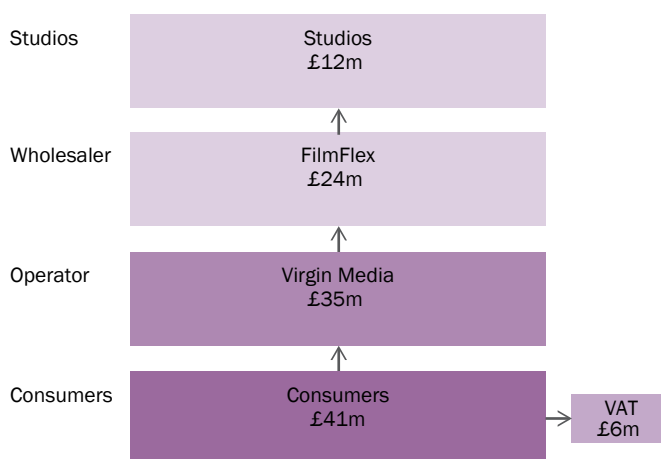
U>direct

286. BSkyB once faced a competitor in the nVOD market in the form of Digital Broadcasting Company (DBC), which was set up in July 1999. DBC was backed by Pearson and Nomura. DBC launched its 17-channel nVOD service branded as U>direct on the Astra satellite in July 1999. U>direct offered films from Hollywood and independent studios (rights were obtained on a non-exclusive basis) and sports, including football and boxing.

287. Whilst U>direct was using Sky's EPG, Sky's Conditional Access and booking system, it was still considered to be a direct rival as it operated at the time when 'Sky Digital' and Sky's own in-house nVOD service had just been launched. The company failed and closed in 2001 and we believe that there were two main reasons for this:

- there were some technical problems with the sports components; and
- more fundamentally, we suspect U>direct overpaid for film rights.

Figure 102: TV-based on demand services – Virgin in the movie VOD value chain



Source: Screen Digest

Figure 103: TV-based VOD – Sky offering

package	content	pricing
movie (recent and classic)	Sky Box Office – nVoD Movies from all six US major Studios	£3.00 - £3.75

Source: Screen Digest from Sky

287-1. U>Direct struggled by trying to compete with 'longer tail' content but with limited 'shelf space'. Moreover, U>Direct lacked scale and bargaining power with Studios compared to Sky which, by contrast, already controlled pay TV window rights. Finally U>Direct was not able to cross-promote the service like Sky does in a cost-effective way for its own in-house services.

Tiscali TV (formerly Homechoice)

288. Whilst it does boast a substantial selection of films and TV, Tiscali TV is marketing its on-demand content as a value-added proposition for IPTV subscribers, with a large array of free content available (though not movies) when customers take the TV packages.

288-1. Although Tiscali is offering a free-TV package (when taken with broadband), customers will be unable to access the majority of TV on demand content unless they upgrade beyond the basic tier. As such, on demand revenues will consist primarily of subscription revenues and those generated through film rentals.

288-2. Tiscali TV has VOD rights for movies from all US Studios and several independent labels, including: Fox, Warner Bros, Disney,

Dreamworks, Sony, Paramount, Universal, Pathé.

BT Vision

289. BT's on-demand proposition is one of the most comprehensive of all of the platforms with on demand services. The relatively low price of premium movies and the comparatively wide range of SVOD packages (not including movie SVOD) is supposed to encourage customer fidelity in the face of competition from online rivals. The addition of on-demand Premiership matches after September 2007 (46 games through Setanta during the 2007/2008 season) is also expected to boost revenues.

289-1. The BT Vision business model makes switching TV services difficult for the consumer. Switching services will require the customer to return their V-Box, losing both a PVR and DTT set-top box. However, the V-Box is in danger of being relegated to being a second set set-top box in households which take broadcast pay TV offers and this could offset the gains made from having a relatively strong on demand offer.

FilmFlex and OGD

290. FilmFlex is a key central player in the VOD value chain in the UK. The Virgin

Figure 104: TV-based VOD – Tiscali offering

package	content	pricing
movie (recent and classic)	1000 movies (all Studios, Pathé etc.)	Pay-per-view: £1.99 to £3.49
TV replay	Catch up – Select BBC/C4 content	Free, but extent of replay limited to TV package selected
free OD	100-400 hours TV	Select free TV content, varies with TV package
V:MX	Music videos	£6.00 monthly fee. Playlist with video skipping function.
kids	ITV/BBC, Cartoon Network	SVoD £6.00

Source: Screen Digest from Tiscali

Figure 105: TV-based VOD – BT offering

package	content	pricing
movies (recent and library)	WB, Universal, Dreamworks	£1.99 to £2.99
TV replay	7 day catch up (Channel 4 only)	£0.99 to £1.49 Or £3.00 SVoD
TV on demand	Popular series/ documentaries	£0.79 to £0.99 Or £6.00 SVoD
kids	Cartoon network/ others	£0.49 Or £6 SVoD
music	Concerts/videos/ documentaries	Videos: £0.29, Concerts: £2.99, SVoD £6.00 (videos only)
sport	Near live soccer matches	242 VoD Premiership games

Source: Screen Digest from BT

Media TV On Demand Movie service is among those outsourced to FilmFlex.

291. FilmFlex, formerly known as MovieCo, is a joint-venture of three players formed in 2004. It comprises one UK-based VOD specialist and two Hollywood Studios: On Demand Group (ODG), Walt Disney Television International and Sony Pictures Television International. The European Commission competition authority formally approved the submission from MovieCo/ FilmFlex for the creation of the joint venture on 12 November 2004.

292. FilmFlex was also the brand name of the consumer front-end of the Movie VOD service available to Virgin Media subscribers, before it was re-branded Virgin TV On Demand. It was launch in Glasgow early 2005 and then rolled-out to all VOD-enabled NTL and Telewest regions, now available to nearly all Virgin Media's digital subscribers.

293. Although Sony and Disney are shareholders in FilmFlex, FilmFlex is offering film titles from the libraries of all other Hollywood Studios, as well as independent filmmakers Pathé and Icon Films.

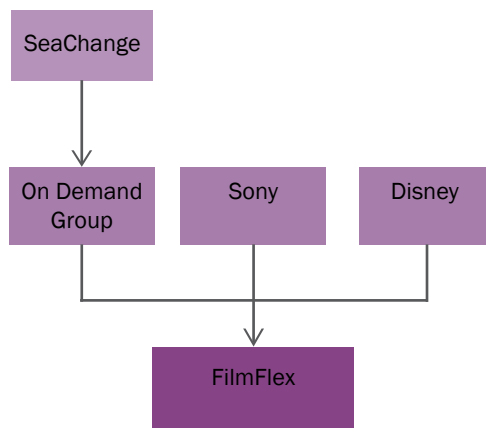
294. The On Demand Group (ODG) was formed in 1995 and is independent and privately funded. ODG specialises in managing and providing full turn-key transactional television services and solutions to telecommunications and media organisations. It has created a range of pay per view, near video on demand and full video on demand businesses for clients in the UK and Europe.

295. The range of ODG services includes service development and operation, content acquisition and aggregation, content management, TV production, advertising and promotion, analysis, and software and service integration. ODG's clients include Front Row, Telenet in Belgium, Telecom Italia, and Mirador in Spain.

296. In 2002, ODG created a non-exclusive strategic partnership with SeaChange International to develop video on demand opportunities worldwide – SeaChange is one of the world's leading VOD server suppliers. SeaChange took full control of the capital stock of ODG in September 2005.

297. ODG manages the Virgin Media TV On Demand content services.

Figure 106: Ownership of FilmFlex



Source: Screen Digest

6 Internet VOD

6.1 Key findings

- **Definition:** the market for Internet VOD (as opposed to TV-based VOD) can be broken down into four sectors: digital rental, digital retail, free and subscription.
- **Enabled homes:** 12m UK households can currently access these services via a broadband connection.
- **Consumption levels:** average buy rates are less than one unit for both retail and rental sectors and are expected to remain this low over the forecast period.
- **Window and terms:** digital retail shares a window with DVD, with some new releases arriving 'day and date' with DVD, as little as 17 weeks after their theatrical debut. PPV digital rental shares a window with its TV equivalent, traditional PPV.
- **Value chain:** there are 'middle men' emerging in the Internet VOD market in the shape of 'white label' services.
- **Consumer spending:** UK consumers spent £500,000 on Internet VOD movies in 2006. In, 2011 we expect annual digital rental spending on movies to have risen to £7m and annual digital retail spending on movies to have grown to £76m.
- **Principal providers:** LoveFilm dominated both retail and rental sectors in 2006 but Sky, BT and especially Apple can be expected to challenge in 2007.
- **Studio revenues:** movie rights-holders secured an estimated 26 per cent of digital rental spending and 50 per cent of digital retail spending in 2006.

6.2 Overview

298. This section assesses the emerging market for Internet video-on-demand (VOD) in the UK. It covers the streaming and downloading of movies over the open Internet on a rental and retail basis.

299. Most content in the Internet VOD market is accessed by downloading, rather than streaming. Downloading is the process of receiving a file and storing it on a hard drive, be that for a limited or indefinite period. The advantages of downloading over streaming are that, once the file is downloaded, it offers more control over playback and, generally

provides superior picture and sound. The benefit of streaming is that the user does not have to wait to receive a file before viewing and can access any part of the file instantaneously. However streamed delivery can only be used for rental VoD as the content cannot be stored permanently.

300. So far all Internet VoD services in the UK have been PC-based i.e. customers download to their computers and either view it on the PC or transfer it from the PC to a secondary device. However, there is an emerging category of devices (such as Microsoft's Xbox 360) which can access the

Internet directly, avoiding the need to use a PC as a central hub. Screen Digest expects the first movies services to launch on these alternative connected devices in the UK before the end of 2007.

301. Internet VOD can broadly be divided into four sectors:

- Digital rental, also known 'download-to-rent', or pay-per-view (PPV) VOD
- Digital retail, also known as 'electronic sell-through' or 'download-to-own'.
- Free VOD, also known as 'ad-supported' VOD
- Subscription VOD, also known as 'SVOD'

302. These sectors remain in their infancy, with 2006 being something of a watershed year for Internet VOD. This is largely due to the proliferation of mainstream movie content in this space, notably from the Hollywood majors which, until fairly recently, had been reluctant to explore online distribution in a meaningful way. However, flattening growth in the DVD market has encouraged the Hollywood Studios to embrace the diversification of video business models. Moreover, the unrelenting threat of Internet piracy makes establishing a legitimate digital marketplace, to offer consumers a legal alternative, increasingly vital.

303. The growth of Internet VOD is being accelerated by the influx of movie downloading services from major companies

- the new 'middlemen' - principally emerging from six core areas of business:
- Telcos and Internet Service Providers (ISPs),
- Pay TV operators,
- Technology companies
- Online DVD rentailers,
- Etailers and retailers,
- Third party 'pure' content aggregators

304. Telcos, such as UK incumbent BT and pay TV operator BSkyB, have employed VOD strategies as one aspect of their churn reduction and incremental revenue strategies to bolster their position in an increasingly competitive broadband access market. For BT, developing an online VoD strategy has gone hand in hand with the development of its IPTV service BT Vision, whereas Sky already holds pay TV rights to premium movie content, and has begun to leverage these in an Internet VOD service. This is a

move designed to protect its existing pay TV subscriber base against encroachment from old and new competitors in the delivery of walled garden services.

305. Meanwhile, international technology companies, such as Apple and Microsoft, have turned to content as a means of pushing highly lucrative hardware and software businesses respectively. Although to date this has largely been for music, TV episodes and other shorter form video content, both companies started offering full-length movies to their customers in the US in late 2006 – Apple via its online content store iTunes and its iPod device, and Microsoft via its Xbox 360 games console and associated Xbox Live online service. Neither service is offering movie downloads in the UK as yet but Screen Digest believes launches from both companies are likely around year-end 2007 or the beginning of 2008. It is important to stress that in the US these device-based solutions represent the top two movie services.

306. In contrast, retailers and rentailers, online and offline, are exploring the provision of movie downloads as an attempt to compensate for the slowdown in the physical video business. Online DVD rentailers such as LoveFilm have been the quickest to move, launching movie download services in an attempt to re-position themselves as 'one-stop shops' for entertainment. The UK's home entertainment retail specialists – HMV and Virgin amongst them – have been far more conservative by comparison, and in so doing have missed an opportunity to get an early start. The arrival of movie downloading services from these bricks-and-mortar retailers would now be considered a defensive strategy. Meanwhile e-tail giants like Amazon and Ebay, having strong positions in the online space, may yet have considerable influence in shaping the market.

307. 'Pure' third party content aggregators, whose businesses are solely based on profitable Internet VOD, are likely to struggle in the face of stiff competition and marketing power of larger rivals. That said, third party aggregators which have deep-pocketed parents or close affiliation with content owners, might fare better than pure independents by virtue of their access to capital and content.

308. Internet VOD service providers are faced with a choice of delivery systems - effectively

between deploying a centralised platform, where content is accessed by the consumer from a central server, or a peer-to-peer (p2p) solution, where content is decentralised and potentially distributed between the computers of all other users registered to a service and regulated by a central server.

309. It is expected, as bandwidth costs decline, that content delivery over centralised systems will continue to become more efficient. However, there is growing acknowledgement of P2P as a more cost-effective form of delivery for the platform (although not necessarily for the consumer's ISP). Some of the more significant Internet VOD platforms to launch in Europe including Channel 4's 4OD service, Sky Anytime on PC and the BBC's media player in the UK have chosen p2p solutions as the basis for their services.

310. Getting Internet VOD content to the living room has been beyond most consumers, with DRM restrictions prohibiting the transfer of files from the users' PC hard drive, and only the tech-savvy able to handle the PC-to-TV technology currently available. However, in April 2007 key player LoveFilm started allowing consumers to burn some downloaded content onto DVD—a feature known as 'download-to-burn'—for playback in standalone DVD players (see digital retail section 6.5 and LoveFilm profile in the principal providers section 6.6 more information).

311. Moreover, while climbing broadband speeds, coupled with advances in video codec compression, mean that it is only a matter of time before the average consumer will be capable of downloading a feature film in less than ten minutes. It should be pointed out that a number of factors mean that the day of truly on-demand, high quality, online video services in the UK is still some time away:

- Low average speed of broadband in the UK (around 2.6Mbit/s in H2 2006);
- Slow deployment of next-generation broadband services such as ADSL 2+ and fibre-to-the-home (FTTH);
- The vagaries of transferring data over the open Internet.

6.3 Market data

6.3.1 Enabled homes

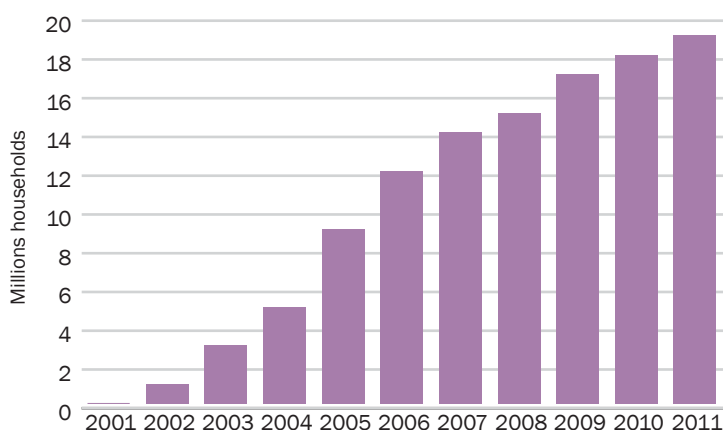
312. The UK broadband market has grown rapidly and now offers fertile ground for budding Internet VOD services. At the end of 2006 around 12m PC households in the UK were equipped with a broadband connection, that is to say an Internet connection with data transfer speeds of at least 150kbit/s in one direction. This translates into a penetration rate of 46 per cent, up from 34 per cent in 2005.

Downloading times

313. The user-friendliness of Internet VOD, depends upon transfer speed. In the UK, the situation is still very different according to the kind of broadband access consumers have.

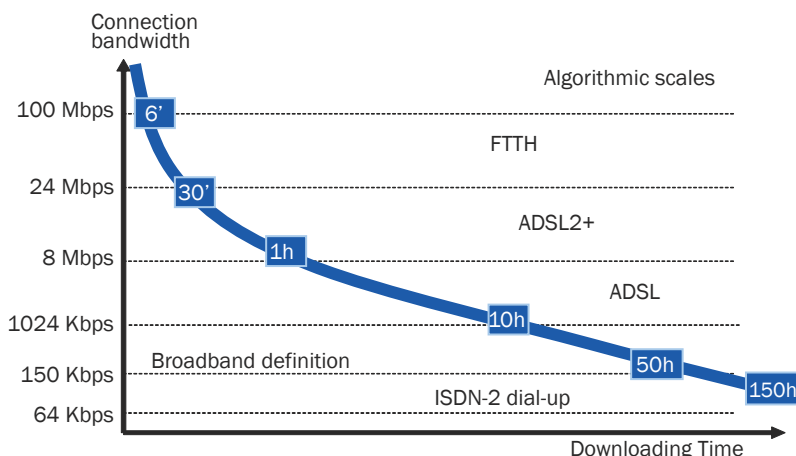
314. Figure 98 shows the downloading time for a 120 minute DVD-quality movie to be downloaded, depending on the bitrate/speed of the connection.

Figure 108: Internet VOD – Enabled homes



Source: Screen Digest

Figure 107: Internet VOD – Downloading time



Source: Screen Digest

315. A typical 120 minute movie in DVD-quality compressed using MPEG-4 is approx 2.4 Gbytes or 19,600 Mbits in size. With a standard 'one meg' bandwidth connection (1 Mbits/s), it would, in theory, take up to 19,600 seconds (approx 5 hours) to download a film. However, a certain 'overhead' transfer time has to be taken into account. A realistic value for normal Internet usage (average filesize less than 25KByte) is 50 per cent overhead, which doubles the practical downloading time to about ten hours.

6.3.2 Total Internet VOD revenues

316. Internet VOD movies have generated modest revenues to date. In 2006, total movie revenues from digital rental and digital retail reached about £500,000. This is significantly higher than equivalent revenues in 2005 however, when UK Internet VOD services only accrued around £15,000.

317. Digital rental dominated the Internet VOD market in its embryonic stages, largely because the studios were more willing in the early stages to offer content on a rental basis than they were for retail. In 2006, digital rental transactions accounted for 45 per cent of the total Internet VOD movies market. This looks set to change in 2007 however, with studios relaxing their policies on retail VOD rights. Indeed, the number of digital retail deals is now outnumbering digital rental.

318. We anticipate that in 2007 digital retail will account for 75 per cent and 92 per cent of by 2011.

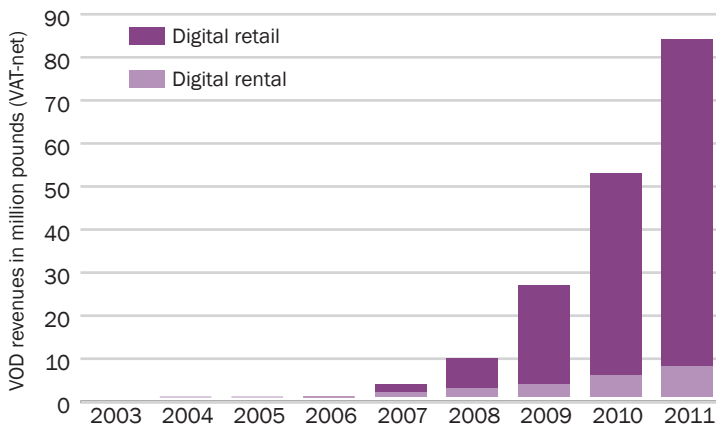
6.3.3 Internet VOD consumption—buy rates

319. The immaturity of the UK's Internet VOD market is borne out by the buy rates (average annual number of transactions per equipped household) for digital rental and digital retail. In 2006, the buy rate for both sectors was less than one unit per household. Even by the end of the forecast period we expect the buy rates for digital rental and digital retail will only be around 0.2 and 0.4 respectively.

6.4 Digital rental

320. Digital rental is essentially the Internet VOD equivalent of PPV TV. Consumers pay a one-off fee to stream or download a movie over the Internet. For content that is downloaded, users are granted a licence to view the content for a limited period—this ranges from one day to one week - after which

Figure 110: Internet VOD – Movie revenues



Source: Screen Digest

Figure 109: Internet VOD – Movie revenues

£m	2003	2004	2005	2006	2007	2008	2009	2010	2011
Digital rental	0	0	0	0	1	2	3	5	7
Digital retail	0	0	0	0	2	7	23	47	76
Total	0	0	0	1	3	9	27	52	83

Source: Screen Digest

Figure 111: Internet VOD – Major content deals in the UK

	Disney	Fox	Paramount	Sony	Universal	Warner	Total
Digital rental	1	1	-	1	1	1	5
Digital retail	-	-	-	1	3	2	6
Total	1	1		2	4	3	11

Source: Screen Digest

it expires and is rendered un-viewable. Services typically allow unlimited viewing for 24 hours once the file has been accessed.

321. There have been attempts in the UK – LoveFilm for example – to introduce digital rental on a subscription basis but rights issues have prevented this (see the Release Windows section 6.7 for more information).

Total digital rental revenues

322. In 2006, digital rental transactions in the UK totalled around 90,000. Based on

an average transaction fee of about £3.30, we calculate that this generated £300,000 in revenues.

323. We expect this to rise over the forecast period but at a slower rate than digital retail revenues. This is because digital rental is a less compelling consumer proposition than its retail equivalent and the experience from DVD suggests that customers are willing to pay for ownership. Screen Digest believes that channels which allow content to be viewed in the living room – DVD, traditional PPV and walled garden VOD services such as the Xbox Live Market Place and iTunes – will continue to be more appealing than the idea of watching a movie on a PC screen. Consequently, we are forecasting that even by 2011 digital rental will only be generating around £7m.

Cashflow chain and margins

324. In 2006, consumers spent £355,000 on digital rental, of which service providers made a net revenue of £293,000 after VAT. LoveFilm accounted for 85 per cent of this, the rest being split amongst the other services. LoveFilm is the only service in our analysis for which some business goes through a portal and, according to our estimates, AOL received less than one per cent of the £249,000 received by LoveFilm.

325. Based on our assumptions about the flow of funds in the market we believe that studios received an estimated £91,000 from digital rental in 2006, giving them a 26 per cent share of gross consumer spending.

326. We have not accounted for minimum guarantees in this model because digital rental deals were being agreed on a piecemeal basis over the course of 2006 and such payments are generally made on an annual basis for a library of titles and usually only apply for deals with the Hollywood majors. Also, minimum guarantees are best thought of as an advance – once the service provider's revenues cover the

Figure 114: Internet VOD – Buy rates

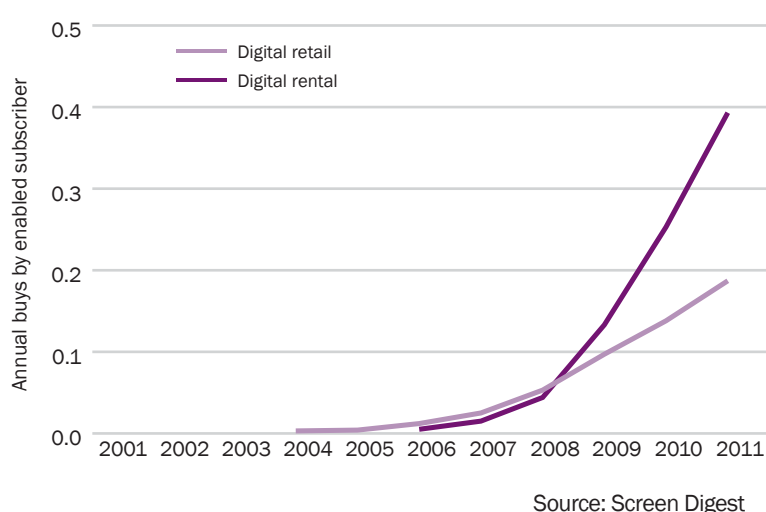


Figure 113: Internet VOD – Digital rental



Figure 112: Internet VOD – Digital rental

		2004	2005	2006	2007	2008	2009	2010	2011
Transactions	m	0	0	0	0	1	2	3	4
Average charge	£	1.8	1.8	3.3	2.6	2.6	2.5	2.5	2.3
Revenues	£m	0	0	0	1	2	3	5	7

Source: Screen Digest

minimum guarantee, all subsequent income is split on a revenue sharing basis. Our research suggests that service providers pay between anything from £100,000 to £250,000 per year depending on the size and the production studio's perceived value of the library.

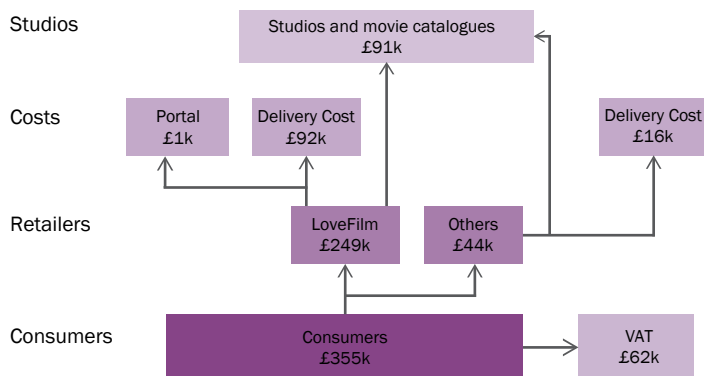
6.5 Digital retail (download-to-own)

327. It is now possible to purchase permanent downloads of, as well as rent, movies in an Internet VOD environment. Under the digital retail business model consumers make a single payment for an electronic copy which they can download, store on their hard drive indefinitely and play at will. To date, digital retail services have been limited to the PC. Stringent copy protection imposed by Studios has made content portability a contradiction in terms, with no download to burn or transfer to secondary devices permitted. Instead, there have been attempts to simulate portability by supplying an additional copy of the downloaded title for handheld media players. One Studio, Universal, has also provided

consumers with a pre-recorded DVD copy of its digitally retailed titles through the post, although this has, of course, come at a premium.

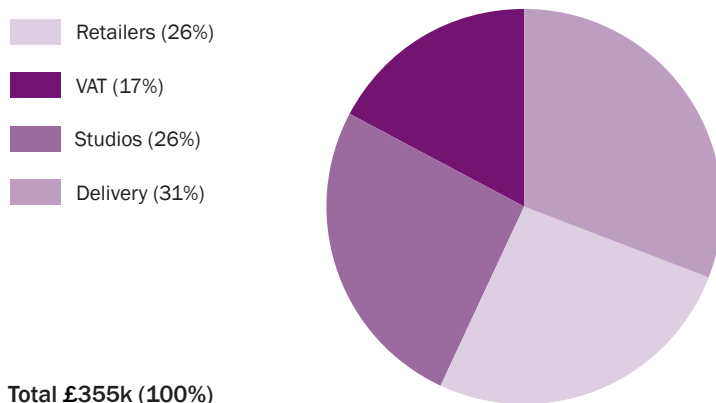
328. However, LoveFilm has announced that it will be offering download-to-burn for select titles from two major Studios beginning in April 2007. This follows a precedent from the US where some of the Hollywood majors have made titles available on a download-to-burn basis, however these moves are tentative—so far there are ~120 titles available for download to burn in the US, the great majority of which are catalogue titles. To date Universal is the only major Studio to have experimented with download to burn titles available day and date with the DVD release. For the most part the major Studios are waiting for a proven DRM-enabled burning solution before releasing premium titles for download to burn. The big sticking point has been the insistence from some Studios (notably Warner, Twentieth Century-Fox and Paramount) that any download to burn solution must support CSS (Content Scrambling System), the DRM solution used on commercial DVDs, despite the fact that CSS was successfully hacked in 1999 and work-arounds are widely available on the Internet. The specification for CSS burning was agreed in principle by the DVD Forum in March 2007, with licensing terms finally agreed in October 2007. However, given that the solution requires consumers to invest in both special writable DVDs and special drives to burn the discs, Screen Digest expects that the uptake of download to burn solutions will be slowed appreciably.

Figure 116: Internet VOD - Digital rental cash flow chain (2006)



Source: Screen Digest

Figure 115: Internet VOD - Share of gross digital rental revenue



Source: Screen Digest

Total digital retail revenues

329. We estimate that UK digital retail transactions were just shy of 20,000 in 2006. Content ranges in price according to whether it's from a major Studio or an independent, and whether it's a new release or catalogue title. Assuming that the average price per transaction was about £12.45, this means the sector generated revenues of close to £250,000.

330. This figure is expected to grow significantly between 2007 and 2011, accelerated by increasing broadband speeds, a wider range of content and the portability provided by download-to-burn, the ability to transfer content to devices beyond the PC, and especially the launch of an iTunes movie

download service. We anticipate that by the end of the forecast period, digital retail will be generating closer to £76m, although it will only be accounting for approximately four per cent of total retail video spending.

Cashflow chain and margins

331. Of the £296,000 UK consumers spent on digital retail in 2006, around £245,000 went to service providers in revenues (VAT-net). We estimate that LoveFilm accounted for £225,000 of this (92 per cent), with the remaining £20,000 being spread among other services. As is the case for digital rental,

LoveFilm is the only service in our analysis which currently conducts some business through a portal. Our estimates indicate that AOL received about one per cent of the revenues accumulated by LoveFilm.

332. Assuming that digital retail deals are agreed on a wholesale basis and that majors and independents receive 65 per cent and 55 per cent of the retail price respectively, we believe that studios received around £150,000 from digital rental in 2006.

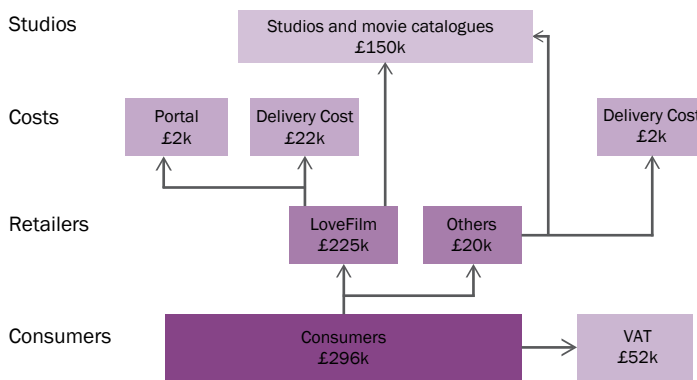
333. Like the digital rental market, deals were not in place in the digital retail space at the beginning of 2006, they were agreed at different points over the year. Minimum guarantees operate on the same principal as they do for digital rental services (outlined above) and as such are not included in our revenue breakdown. Industry sources indicate that service providers pay a studio a minimum guarantee of up to £100,000 for a digital retail library, depending on which titles are included.

6.6 Principal Providers

334. Both the retail and rental sectors of the Internet VOD market were dominated in 2006 by early mover LoveFilm, which is therefore the only provider profiled. Other services were operational in 2006 but were launched later in the year so were not able to establish themselves as true competitors in 2006. However, these services can be expected to pose a greater threat to LoveFilm's dominance over the forecast period.

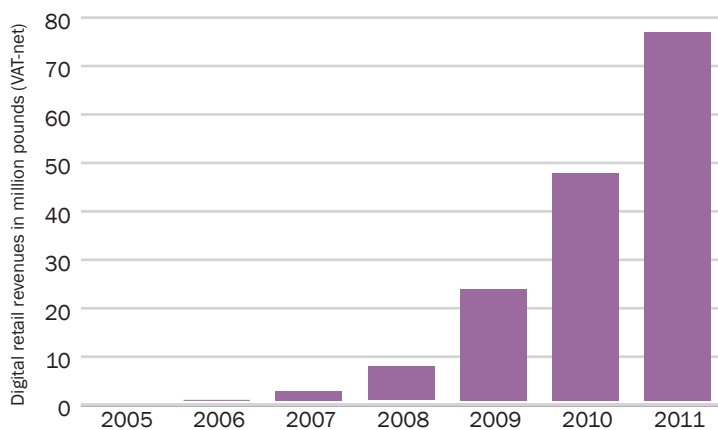
335. On the rental side, Sky Anytime on PC will offer some competition. Launched in January 2006, the service generated 1m downloads in its first year. However, the vast majority of these were provided free to Sky's existing pay TV customers, so are not counted in our market figures. Sky's download service is essentially a value-add for its pay TV users, offering a library of 500 titles for download from studios such as Universal, Twentieth Century-Fox and Disney. It was only in

Figure 119: Internet VOD - Digital retail cash flow chain (2006)



Source: Screen Digest

Figure 118: Internet VOD – Digital retail

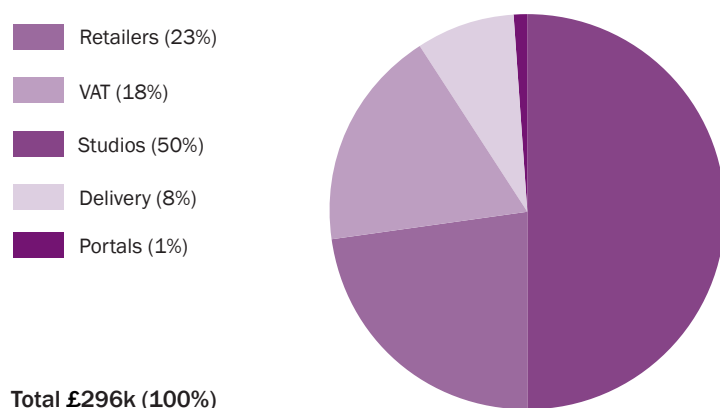


Source: Screen Digest

Figure 117: Internet VOD – Digital retail

		2004	2005	2006	2007	2008	2009	2010	2011
Transactions	Million	0	0	0	0	1	2	4	7
Average charge	£			12.4	14.3	13.0	12.1	11.9	11.7
Revenues	£m			0	2	7	23	47	76

Source: Screen Digest

Figure 120: Internet VOD - Share of gross digital retail revenue

Source: Screen Digest

December 2006 that the service was expanded to include an additional selection of 30 films on a PPV rental basis. It is this element of Sky Anytime on PC which could rival LoveFilm going forward.

336. Sky is well positioned to enter the digital retail market as well, having already established an online download service and boasting strong relationships with content providers. If Sky does opt to launch a retail service it will face competition in the short term not only from LoveFilm, but also from BT. The UK incumbent telco began offering movies for download on a retail basis in July 2006 as part of its PC VOD service. However, the service has not been promoted very much which could explain its slim share of the market. The service currently offers upwards of 150 titles from Warner and Universal for download-to-own and is due to be augmented with digital rental in late 2007-early 2008.

337. The Internet VOD landscape can be expected to change dramatically over the forecast period with other principal providers

likely to emerge, notably Apple, Microsoft and Sony.

337-1. Apple launched digital retail in the US in September 2006 through its iTunes Store and almost immediately became the number one movie service in the US despite only having content from Disney. Since then the company has signed deals with Paramount (for library content) and Lionsgate. iTunes movies are expected to launch internationally around the end of 2007 and the beginning of 2008. Apple's service is Internet-based, centred on its iTunes jukebox software, and does not allow content to be burned to DVD. However, iTunes allows content to be moved away from the PC and content can be consumed either on the iPod or Apple TV set-top box which launched in March 2007.

337-2. Microsoft launched movies to US users of its Xbox Live Marketplace in December 2006, and has become the second largest provider of online movies in the US after Apple. Microsoft only offers movies on a digital rental basis. However, by supplying content direct to the Xbox games console this content is already available on the TV rather than being restricted to PC viewing. Significantly the company also offers HD content, which Screen Digest believes accounts for an appreciable proportion of sales. A UK version of the service is likely to arrive around the end of 2007 and the beginning of 2008.

337-3. Sony is yet to launch an online movies service, but the company has announced plans to sell video content direct to its PS3 games console. As with the Xbox, this has considerable potential to reshape the online movie market in the UK because it gets content to the living room.

Figure 121: Internet VOD – Main providers

Service	Ownership	Studio deals	Terms	Digital rental market share (% of volume)	Digital retail market share (% of volume)
LoveFilm	LoveFilm International	Sony, Universal, Warner	Digital retail, digital rental	85	92
Wippit	privately owned	Universal	Digital retail	-	5
BT Vision	BT	Universal, Warner	Digital retail	-	3
Sky Anytime on PC	BSkyB	Disney, Fox, Universal	Digital rental, free	15	-

Source: Screen Digest

LoveFilm

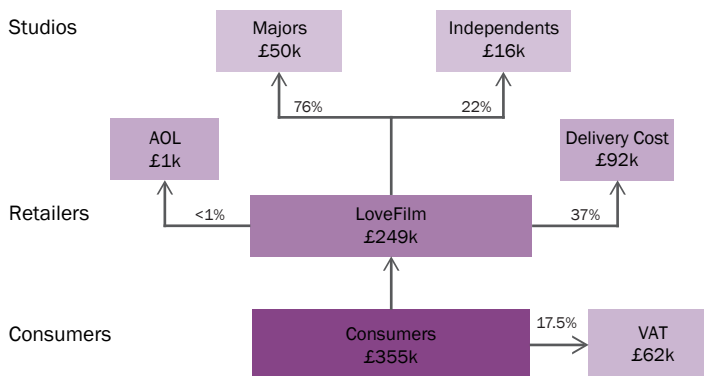
338. Rentmailer LoveFilm was the first company in the UK to offer movies from the Hollywood majors on a download basis. The rentmailer is the distribution partner for Arts Alliance Media (AAM), a digital film content and technology provider which has secured a number of Internet VOD deals. AAM content is also distributed through its own download service Vizumi, AOL Film Downloads and Tiscali's Movies Now.

339. LoveFilm launched its download business in February 2006 with digital rental, so has benefited from first-to-market advantage. It now offers a range of titles from majors and independents and in 2006, accounted for an estimated 85 per cent of the digital rental business in the UK. LoveFilm might be able to weather the oncoming storm from the likes of Apple and Microsoft by driving interest in its PPV and other content with free, ad-supported downloads. In February

2007 LoveFilm launched a service which allowed users to download a selection of independent films for free that are sponsored by advertising. Volkswagen (VW) was the first sponsor for titles on this basis. Under the deal, the VW brand appear across the LoveFilm domain. Users are required to install a LoveFilm download manager on their PC to view content for free, in which short VW adverts will show in the left-hand pane as the movie downloads in the right-hand side. Once downloaded and opened, a short Volkswagen advert (under a minute in length) also shows before the movie begins. The content is protected by Windows Media DRM and is available for access for seven days following download for a viewing period of 24 hours once the file is accessed.

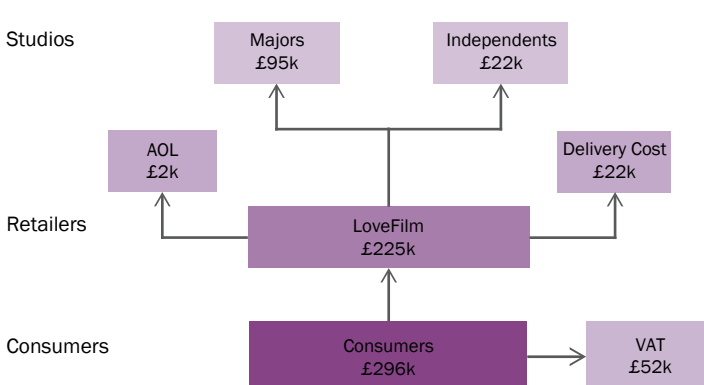
340. In April 2006 LoveFilm expanded its service to include digital retail after AAM agreed a deal on this basis with Universal, the first such deal with a Hollywood major in the UK, and indeed Europe. The deal was also notable because it debuted Universal's '3 copy' model, where consumers receive three copies of the film they download; a digital copy for storage on a PC/laptop, a digital copy for storage on a Windows Media-compatible portable device, and a pre-recorded DVD copy of the title, the latter being despatched by post. In October 2006, Sony – also using the '3 copy model' - expanded the list of AAM digital retail content partners and, subsequently, LoveFilm's digital retail offering. Then, in December, Warner joined the list of major contributors to LoveFilm's digital retail service. The relative size and range of the rentmailer's digital retail library helped earn it an estimated 92 per cent share of the market in 2006.

Figure 122: Internet VOD - LoveFilm in the digital rental value chain



Source: Screen Digest

Figure 123: Internet VOD - LoveFilm in the digital retail value chain



Source: Screen Digest

341. The download-to-burn facility that LoveFilm launched in April 2007 may help to preserve some of its market share. LoveFilm now allows users to burn selected digital retail titles to a blank DVD for playback in standalone DVD players. At launch, 100 catalogue titles from two major Studios – one of them Sony – were available on this basis. The service currently uses German company Ace's FluxDVD with its SecureBurn disc protection technology for the burning and encrypting process but following the approval by the DVD CCA of CSS burning in October 2007, Screen Digest expects LoveFilm to adopt the latter.

341-1. LoveFilm has implied that it would be interested in expanding its digital rental offering to include subscription VOD - not least because this business model mirrors that it employs for its DVD rental service and would therefore allow them to offer a hybrid physical-digital rental subscription. However, the company has found the rights issues in the subscription rental window a barrier to entry (see Release Windows section 6.7 for more information).

6.7 Market-specific issues

New release v. catalogue

342. The age of a title has a significant bearing on its value in traditional distribution channels and this is no different in the Internet VOD market. First, the proportion of new releases in a library of titles affects the minimum guarantee attached to a content deal. Then, in the case of digital rental deals, which are agreed on a revenue sharing basis, the content provider will look to secure a higher proportion of the revenues for a new release than they would for a catalogue title. This is more common in the case of the Hollywood majors, which can negotiate more favourable terms. Typically, majors will agree a 50:50 split of revenues for new releases and a 40:60 split (in favour of the service provider) for catalogue titles. Revenue sharing deals for independent content are generally agreed at a flat rate, with 40 per cent going to the studio and 60 per cent for the service provider.

343. For digital retail deals, which are essentially wholesale agreements, studios will demand a higher trade level price per unit for new release titles than for catalogue titles. Again, the major Studios are often able to secure better terms than independents. We estimate that, as an average across all titles, the major Studios' wholesale unit price represented about 65 per cent of the consumer level price, versus about 55 per cent for independents.

344. In both cases, be it a rental fee or a retail price, the service provider will charge a corresponding premium for new releases at consumer level to account for the supplementary cost paid at trade level.

345. Screen Digest expects these margins to come under significant pressure with

the launch of movies through iTunes. For Apple, selling content is a way of promoting hardware sales and the company is prepared to live with small content margins for the sake of hardware sales. There is no reason to think that the company will change business model when it launches in the UK. Screen Digest understands that in the US, new release movies on iTunes cost \$14.99 (£7.63) (often several dollars less than the equivalent DVD release) of which \$14.50 (£7.38) goes to the studio. Even before deductions for operating costs, Apple's margin is therefore as low as 3 per cent. According to industry sources the company does a little better on library titles the company—the retail price is \$9.99 (£5.06) of which about \$7.00 (£3.56) goes to the studio. If the UK online movie market goes the same way as the UK online music market, the launch of iTunes will result in a significant reduction in price as third party services try to compete with Apple. This price reduction has probably helped to grow the online music market, and customers have benefited from lower prices, but it has also resulted in the margins for third party service providers being squeezed. At present, titles from LoveFilm generally range from £9.99 to £19.99 - in the event of an Apple launch these prices and the margin they afford seem unsustainable.

The long tail

346. Internet VOD is arguably the biggest opportunity for the long tail. Like the online players in the physical video market, Internet VoD services can exploit their 'elastic walls' to offer a broader range of titles. Internet VOD services are at an even greater advantage regarding the long tail, as they do not even have the physical storage costs that retailers have to bear for warehousing. To this end, Internet VOD services will be more inclined to offer niche titles because the cost of doing so, in relative terms, is low, compared with the equivalent expense in other distribution channels.

347. Principal provider LoveFilm is one of the services in the UK which subscribes to the long tail theory and has augmented its library of major titles with independent and short content accordingly. By offering a broader range of titles, services like LoveFilm can generate incremental revenue, that is to say revenue from niche or catalogue titles (the long tail), in addition to the revenues generated by mainstream, major new releases.

348. Internet VOD services are also able to increase the potential of the long tail by manipulating the architecture of their online store to tailor it to the interests of each user. By tracking consumers' transaction patterns, services can use sophisticated recommendation engines to direct users to content they are more likely to be interested in and therefore increasing the possibility of a transaction.

Release windows

349. Digital distribution has widened the value chain. Now, alongside traditional platforms for movie content, there exists an electronic equivalent.

350. Digital retail is the counterpart for physical video retail, specifically DVD. Consequently, it shares the latter's release window, with new releases increasingly available for download day-and-date with the titles' DVD release, around 17 weeks after theatrical debut on average.

351. The window for digital rental falls later, usually 6 months after a title has been released at the cinema. This is in line with the window for PPV TV, the traditional platform with which digital rental shares the most characteristics. Both digital retail and digital rental windows are adhered to at distributors' discretion. In some territories - France for example - release windows are mandated by law, but not in the UK. Here, should a distributor wish to make a title available for digital retail ahead of its theatrical run, it is free to do so, although it may find cinema chains less willing to exhibit the film if it has been exploited in an earlier window.

352. There are instances however, where rights deals – especially for major titles – preclude prior, or indeed, simultaneous exploitation in certain windows. This has been the obstacle for SVOD, not just in the UK but most major markets, because pay TV operators – Sky in the case of the UK – have exclusive rights to content in that window. These companies are using their clout to expand existing deals to include Internet distribution and looking to leverage these rights in a Internet VOD environment in services like Sky Anytime.

353. As for free VOD, this sits alongside free TV in the value chain, in a window that falls 27 months after theatrical release.

Looking ahead

354. The growing number of broadband households will expand the potential consumer base for Internet VOD services. With penetration of PC households expected to exceed 71 per cent by 2011 there will be around 19m households equipped to use Internet VOD services.

355. And crucially, these broadband households will have access to content at a faster rate than they do currently. At the moment, depending on connection speed, consumers of Internet VOD can be forced to wait several hours to download a movie. If they are subsequently burning it to DVD it will take even longer. However, the average broadband speed is increasing steadily, bringing the market closer to the provision of true 'on demand' content.

356. Meanwhile, the amount of content available in the Internet VOD space can be expected to grow as the major Studios increase their involvement and independents explore the opportunities afforded them by the long tail.

357. The number of services operating in this area can also be expected to increase in the short term, although in the longer term we anticipate there will be consolidation as the key players establish themselves. Powerhouses like Apple will be amongst those at the forefront of the digital delivery of movies.

7 Premium Movie Channels

7.1 Key findings

- **Market status:** BSkyB is the main company offering premium window movies, either on satellite (Sky Digital) or on cable and IPTV through wholesale agreements with operators.
- **Business terms:** BSkyB has ongoing film supply agreements (output deals) with all of the major Studios.
- **Movie window:** the pay TV window is 9-12 months after video release.
- **Value chain:** BSkyB acquires and transmits library movies and TV movies as well as first-run titles. In line with most pay-TV platforms, BSkyB is understood to licence films for a maximum of three years. Pricing of contracts is principally defined by the number of premium pay subscribers.
- **User base:** Sky has currently about 5m subscribers to its Premium Movie package but the proportion of BSkyB subscribers taking its movie channels is declining.
- **Distributor revenues:** out of the £673m of revenue that can be attributed to Premium Movie subscriptions in 2006, BSkyB paid about £310m of rights to the studios.

7.2 Overview, general terms

358. The core of the films offered by 'premium' movie channels is first-run Hollywood blockbusters, usually secured under exclusive contracts. The premium pay TV window opens approximately twelve months after theatrical release in the UK.

359. British Sky Broadcasting (BSkyB) is the main company offering premium window movies, either on satellite (Sky Digital) or on cable and IPTV through wholesale agreements with operators. The company has around 5m subscribers to its film channels on direct-to-home and cable in the UK and Ireland.

360. Channel 4 Broadcasting's Film Four channel converted from a subscription to an advertising-funded service in July 2006. It was estimated that Film Four had 300,000

subscribers at the time, but was running at a loss. But even as a pay channel, Film Four did not compete directly with Sky, focusing instead on independent cinema and classic movies.

General terms with studios – Premium window

361. This section outlines what we believe are typical general terms. It is based on our understanding of the industry practices.

362. Sky is usually in contract with all of the major US Studio suppliers and at least one independent distributor - Entertainment.

363. In November 2006, BSkyB claimed to have exclusive premium-TV agreements with all of the six Hollywood Studios: Disney, Twentieth Century-Fox, Sony, Pictures, Paramount, Universal, Warner Brothers.

363-1. Deals with Disney, Sony and Twentieth Century-Fox had all been renewed over the last two years. BSkyB's agreement with Disney was renewed in February 2006. The Sony deal was renewed in May 2007.

Terms

364. Exclusive agreements with the film Studios are 'output deals' which run for several years. Despite intervention by the European Commission aimed in part at limiting the term of contracts to no more than three years, we understand pay TV contracts typically last for up to five years.

365. The EC competition directorate opened an investigation into the contracts between Hollywood Studios and pay TV companies in 2002. One of the points at issue was the so-called 'most favoured nation' (MFN) clauses in Studio contracts which provided that favourable terms negotiated by any one US Studio in its contract with a pay TV platform would be offered to all beneficiaries of MFN clauses. MFN clauses, however, typically did not include unit pricing and volume.

366. The EC was concerned about 'alignment' of terms by the Studios that could be considered a cartel behaviour, and said that

it found a 'proliferation' of the MFN clauses in the contracts that it investigated. Without admitting a violation of competition law, six of the studios decided to waive the MFN clauses in their existing agreements. The EC then closed the investigation and stated that insofar as they do not deviate from this new behaviour, further action was not envisaged against them. However the investigation remained open in respect of NBC Universal and Paramount Pictures, which have not followed suit.

367. We understand that BSkyB typically acquires the right to show a film 24 times over a 12-month period.

Windows and rights

368. The pay TV window follows 9-12 months after the home entertainment window and lasts for 12 months.

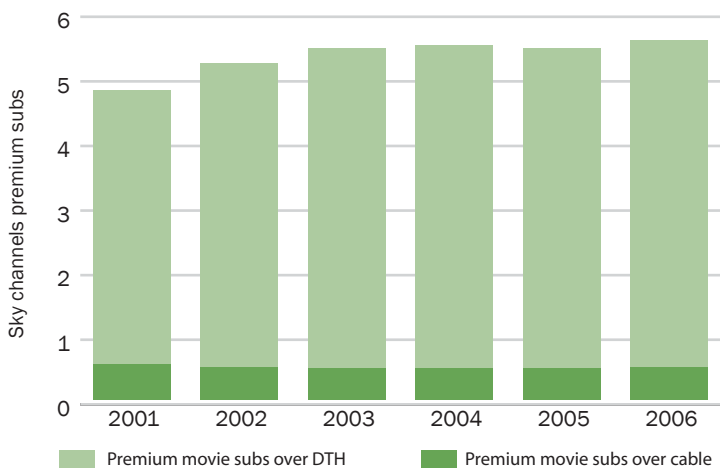
Pricing

369. The most significant ingredient of the pricing of pay TV contracts is the number of premium subscribers. In the case of some platforms (e.g. Germany's Premiere), payments are also linked to the general cost of living. Currency changes can influence the cost of an output deal as a significant portion of contracts are paid in US dollars.

370. When (re)negotiating an output deal, a number of ex ante factors determine the grid of payment to US Studios. Some are related to the films themselves like the a priori potential of the film slate, over which the pay TV operator has little influence or even knowledge—it is rare for pay TV operators to know even the planned titles in the later output years, let alone their potential value.

371. We estimate that Hollywood Major Studios' new titles account for about 50 per cent of BSkyB's Movie channels film broadcast volume (transmissions). Library titles and independent titles make up about 50 per cent too, in a fairly stable balance. In terms of budget, the non-output movies probably

Figure 125: Premium Movie Channels – Sky Subscribers (DTH, cable)



Source: Screen Digest

Figure 124: Premium Movie Channels – Sky Subscribers (DTH, cable)

	2001	2002	2003	2004	2005	2006
Premium movie subs over cable	0.55	0.50	0.49	0.49	0.49	0.51
Premium movie subs over DTH	4.23	4.70	4.95	5.00	4.95	5.05

Source: Screen Digest

account for only 10-15 per cent of total movie costs and the Hollywood output titles for 85-90 per cent. Non-output films are acquired from independent distributors, often on a title-by-title basis. In that case, the value of one film is typically based on 10-15 per cent of the UK box office. Some independents can have output deals which reflect the terms of the Major Studio deals, but heavily discounted, as they clearly lack the same strategic value.

372. Output deals may include some films that have not been released in the cinema in the UK.

7.3 Market revenues

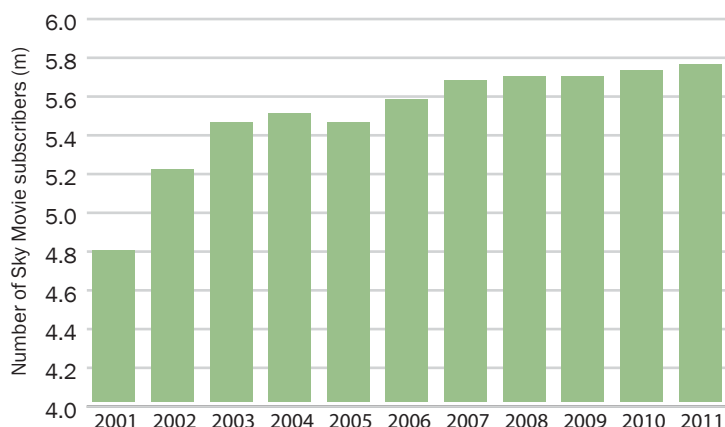
373. We have made a number of key assumptions in our revenue forecasts.

373-1. (assumption 1) The percentage of BSkyB subscribers taking its premium film

channels declines slightly as a percentage of overall subscribers. This percentage has already started to decline. There are a number of reasons:

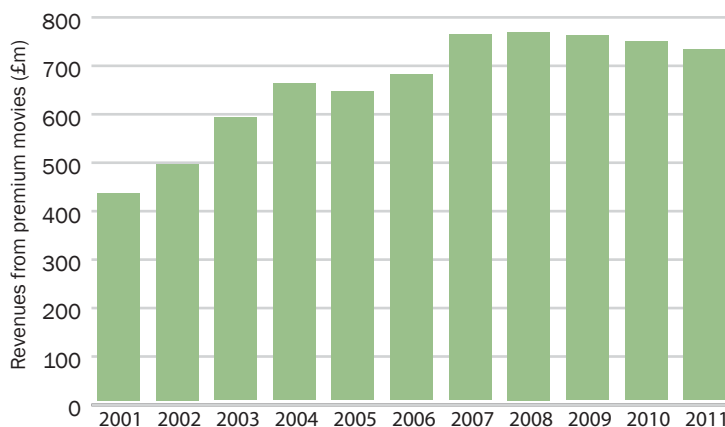
- the increased penetration of DVD players, and affordability of discs. Due to the erosion of prices and widespread availability of cheap DVDs (including promotional DVDs in the daily newspapers) it becomes easier and less expensive to see a movie before it comes to the premium window;
- the increasing availability of films on near-video-on-demand and video-on-demand;
- most of the pool of early adopters and affluent customers (motivated by premium content and ready to pay for it) already subscribe to BskyB;
- greater appeal of other services offered by BskyB such as basic channel packages, sports, PVRs and broadband. PVRs in particular allow consumers to enjoy the great variety of movies broadcast on free-to-view channels and act as a partial substitute for a film channel.

Figure 127: Premium Movie Channels – Total Subscriber forecast



Source: Screen Digest

Figure 126: Premium Movie Channels – Net revenue from subscribers



Source: Screen Digest

374. Audience data collected by Barb in multichannel homes indicates a declining audience for film channels. Viewing of the Sky film channels was half an hour a week in 2007, compared to just over one hour in 1999. In comparison, overall viewing of multichannel TV was slightly higher in 2007.

375. The offer of movies in high definition quality will probably act against this trend but not to the point of reversing it. BskyB has understood that and has launched two Movie channels in HD quality, the first in May 2006. Because of the HD format war we do not anticipate a strong early uptake for HD DVD and Blu-ray players, so that the combination of a Sky Movie subscription, a Sky HD box and a Sky HD fee (additional £10 a month) will remain the best option in the mid-term for 'sophisticated' movie lovers.

375-1. (assumption 2) The spending on movie rights per household (the total invested by BskyB in film rights divided by the number of premium film channel subscriptions) remains broadly the same until 2011.

376. The total amount spent by BskyB on film rights has declined in recent years because it has negotiated more favourable contract terms and the value of the US dollar has declined against the pound. We have taken the

view that because these contracts have been renegotiated fairly recently (many of them in 2006), there will not be a significant worsening in terms from BSkyB's point of view when they are renewed.

Subscribers and subscriber revenues

377. Slightly fewer than half of all BSkyB customers subscribe to the premium movie channels. At 30 June 2006, BSkyB reported 5 million subscribers in the UK and Ireland to either Sky Movies 1 or 2. Some 97 per cent subscribe to both channels. This represents 41 per cent of the overall cable and DTH subscribers reported by BSkyB at the same point. Over the last few years, premium film subscriptions have declined as a percentage of overall subscribers. At 30 June 2002, BSkyB reported 4.6m film channel subscribers, or 45 per cent of the total. In comparison, 5.8m of

BSkyB's subscribers (48 per cent of the total) took its sports channels on 30 June 2006.

378. From the numbers of 'premium' subscribers published by BSkyB, occasionally broken down between movie channels and sports channels, we have estimated the number of movie subscribers at year-end. We believe it was close to 5.5m at the end of 2006.

379. The arrangements for Premium channels distribution between BSkyB and Virgin Media are different and separate from those involving basic channels. While Virgin used to pay a flat fee plus a per-subscriber fee to BSkyB for its basic channels, we understand Virgin pays a purely 'retail' price for premium channels, i.e. they pay per channel, per subscriber, per month, without any minimum guarantee. We have no information on the 'margin' made by Virgin on the distribution of Sky's premium channels.

380. Of the total BSkyB revenues, and according to our modelling, we believe £673m can be attributed to movie channels, out of a total of approximately £3bn in 2006.

Payments to movie rights-holders

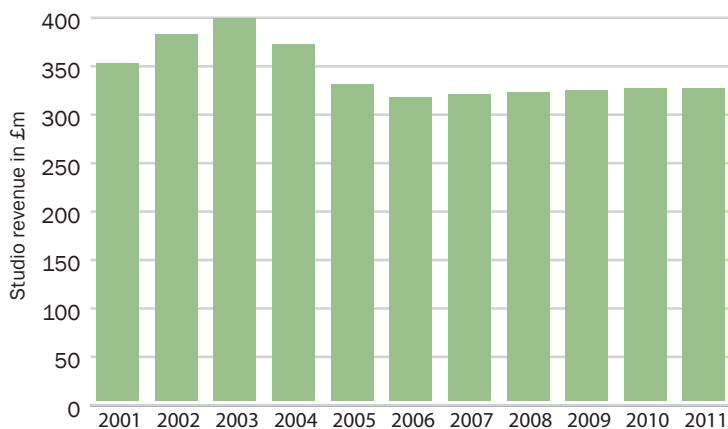
381. BSkyB quantifies its expenditure on feature film rights in its annual reports. We have used these figures up to 30 June 2006 and then transformed them into full-calendar-year numbers. Forecasts have been estimated on the basis of the forecast growth of subscribers to BSkyB over the next five years.

Market shares

382. Studio-level revenues from pay TV have been estimated on the basis of the prior year box office. This methodology is imperfect because contracts are not solely based on box office revenue (though they are partly based on forecast performance). In addition, thanks to their output agreements, it is very likely that the major Studios gain a disproportionately higher share of movie rights spending than independents, as the independents are competing for the leftover slots on the BSkyB film channels and are in a weaker negotiating position. Studios also supply library features along with first-run movies released in UK cinemas 12 months before the pay window.

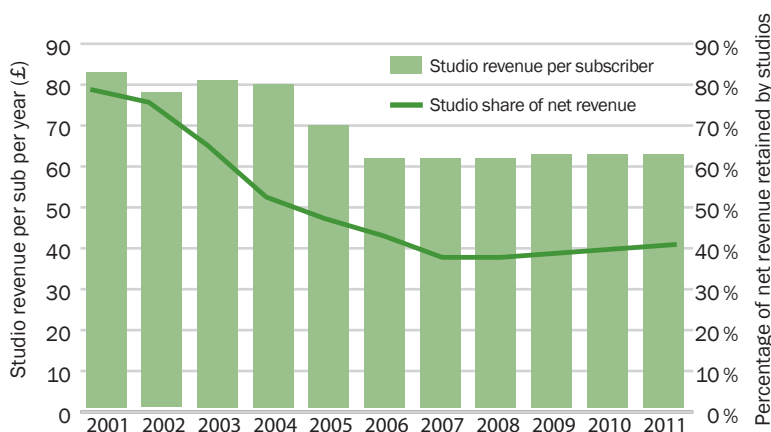
382-1. However, we feel that the UK box office achieved by studios is a clear measure of

Figure 129: Premium Movie Channels – Payments from BSkyB to movie providers (calendar years)



Source: Screen Digest

Figure 128: Premium Movie Channels – Revenue sharing between BSkyB and movie rights-holders



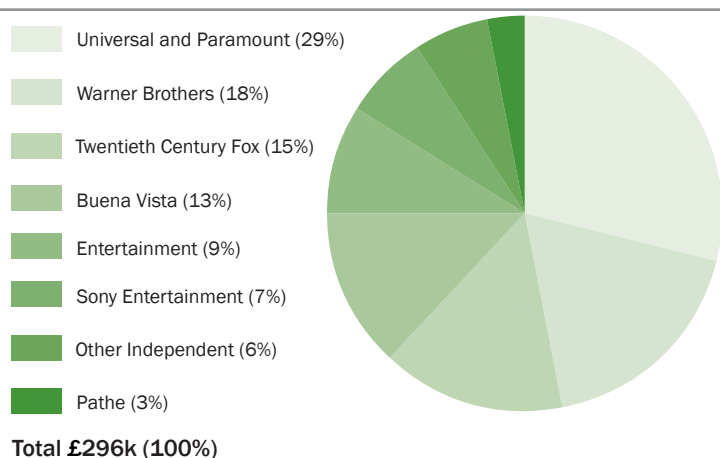
Source: Screen Digest

the importance of their output to BSkyB and the strength of their production slates, and a reasonable substitute.

Cashflow in the value chain

383. Of the £791m paid by UK customers in 2006, the net revenue after VAT (17.5 per cent) was £673m. Of that we estimate BSkyB paid 45 per cent (£313m) to movie rights-holders, of which about 80 per cent went to Hollywood Studios.

Figure 130: Premium Movie Channels – Studio Market Shares 2006



Source: Screen Digest

Figure 131: Premium Movie Channels - Studio revenues from pay TV¹

£m	2001	2002	2003	2004	2005	2006	2007
Buena Vista	78	53	61	97	47	40	49
Sony Entertainment	45	34	49	35	33	21	52
Twentieth Century-Fox	35	34	71	32	35	45	66
Warner Brothers	27	62	61	39	48	57	26
Universal+Paramount	96	120	50	83	97	92	59
Entertainment	15	37	66	54	26	29	25
Icon	10	14	4	3	8	0	3
Momentum	0	9	8	5	7	6	7
Pathé	25	8	9	7	9	11	10
LionsGate UK	7	0	0	3	4	0	8
Tartan Films	0	0	0	2	2	0	1
Optimum	0	0	0	1	4	2	1
Others	9	8	17	8	8	10	10
Total	348	378	395	369	327	313	316
of which Hollywood Studios	282	303	292	286	260	255	252
of which Independents	66	75	103	83	67	58	65

¹ BSkyB has deals with all the studios and distributors mentioned in this table. The market share have been estimated top-down by applying the box office market share of the same studios one year before (as we know BO performance is a key factor in Premium rights valuation).

Source: Screen Digest

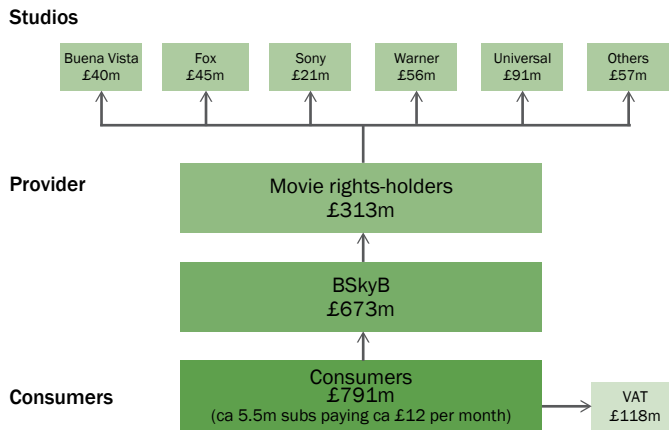
7.4 Principal provider: BSkyB

Description of the offering and pricing

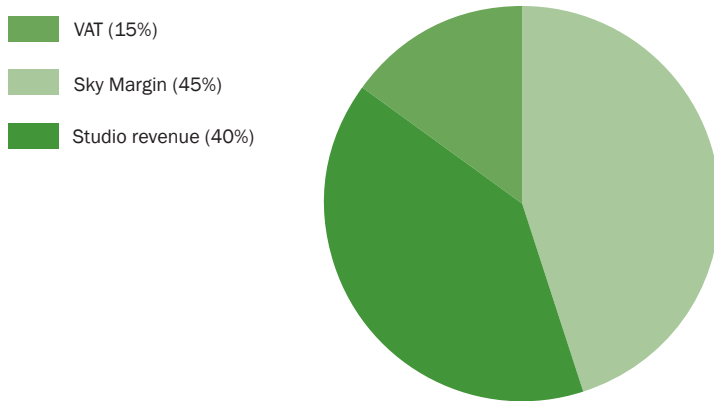
384. Early 2007, the 'Sky Movie Package' or 'mix' consists of:

- 'Sky Movies' Channels (10 channels or 'screens', including 2 in HD quality (Sky Movies 9 and 10): recent movies (most of which are blockbusters), some TV movies
- 'Sky Cinema' Channels featuring re-runs, catalogue movies, classic movies
- The 'Disney Cinemagic' channel and a multiplex version which are bundled with the premium film channels. These channels are free bonus channels for Movies Mix subscribers which are also available as Stand-Alone Premium Channels at an additional £5 per month.

385. Since April 2007, the Sky Movies channels 1 to 10 have been revamped and re-named to relate to specific film genres: comedy, family, classic, action and thriller, sci-fi and horror, drama, indie, modern greats and premieres. Following the rebranding, BSkyB's movie channels were to remain located on their existing EPG positions on the BSkyB platform, renamed and repackaged in order to reflect their new genre focus.

Figure 133: Premium Movie Channels – Cash flow chain 2006

Source: Screen Digest

Figure 132: Premium Movie Channels – Revenue sharing in 2006 (total £791m)

Source: Screen Digest

386. As for the pricing, depending on the number of basic mixes taken by the subscriber (one to six), the movie premium package comes between £34 and £38 per month. A simple calculation shows that for consumers taking just the movie option and not the sports mix, the movie option comes with an additional premium fee of £17 or £18 in addition to the corresponding basic fee. The Sports option has the exact same pricing scheme. For consumers taking both premium mixes (sports and movies), the premium fee in addition to the basic fee, is £24 or £25.

387. A high definition subscription costs an additional £10 per month plus a one-off fee of £299 for the decoder and a £60 installation fee.

388. Virgin Media distributes the BSKyB film package for an additional fee of £16.50 to £30 a month (depending on the package of basic

channels). Sky Movies is available on its own for between £13.50 and £28 a month.

Studios supplying BSKyB

389. BSKyB has ongoing output deals with all the US Studios:

- Walt Disney
- Twentieth Century-Fox
- Sony Pictures
- Paramount
- Universal
- Warner Brothers

389-1. Independent studio Entertainment (which distributes New Line Cinema releases in the UK) is also understood to have a current output deal.

390. The only agreement which has been officially announced is with Disney. The agreement included the launch of the Disney Cinemagic channel and the addition of other Disney channels to the BSKyB services as well as an extension of the exclusive pay TV deal.

391. As part of its current agreement with Disney, which ran from the beginning of 2006, Sky added a new channel to its line-up called Disney Cinemagic*. The channel is marketed as a stand-alone option or as a free add-on for customers subscribing to both Sky Movies 1 and 2. Disney Cinemagic has a first-run window for all Disney group animated and children features (like The Incredibles) and also shows archive Disney animation like Lady and the Tramp and Cinderella. Cinemagic is not showing movies from third party production companies. Other Disney group films (such as live action movies from its Touchstone, Miramax and Hollywood Pictures Studios) continue to be licensed to Sky's premium movie channels. Disney has always carefully controlled the licensing of its animated features and these often received their UK premiere on the Disney Channel.

** Disney Channel used to be the brand of Disney's premium channel, now renamed 'Disney Cinemagic'. 'Disney Channel' still exists but is now a basic channel showing mostly cartoons.*

7.5 Pay TV issues

The long tail: new releases vs catalogue revenues

392. BSkyB's output deals include first release and library feature film titles. Because these titles are bundled together, it is difficult to isolate the cost of individual titles. However, it is clear that packages are driven by titles which have been successful at the box office and are capable of generating strong audiences. The most successful films on BSkyB generate cumulative audiences of up to 5m individuals (achieved by *Gladiator* in 2003).

393. On the face of it, subscription services bear little relation to the long tail phenomenon observed in online DVD retail and rental services. Customers play a flat monthly fee to receive a service which does not depend on their actual consumption. In addition, a key advantage of output deals from the supplier's point of view is to enable it to sell weak titles by bundling them with stronger ones.

394. In 2003, BSkyB said that the 100 most-viewed films (of the 2000 shown per year) accounted for 96 per cent of its audiences. This concentration on hit titles is similar to that of cinema.

2nd and 3rd pay TV windows

394-1. BSkyB buys exclusive premium-TV rights and there are no second or third pay TV windows in the UK. In the UK the window that follows premium pay TV, is shared between Free-to-air terrestrial TV and basic cabsat TV. Multiple pay TV windows were an issue in France when TPS launched a premium channel to compete with Canal Plus, and tried to secure an exclusive window coming after the Canal Plus window and before free-to-air.

Figure 134: Premium Movie Channels – Current BSkyB pricing (£/month)

Packages	Type	Number of basic mixes (£/month)					
		1 Mix	2 Mixes	3 Mixes	4 Mixes	5 Mixes	6 Mixes
Basic mixes alone	basic	16	17	18	19	20	21 ('Entertainment' pack)
Movies Mix	premium	18	18	18	17	17	17
Basic+ Movies	premium	34	35	36	36	37	38 ('Movies plus entertainment' pack)
Sports Mix	premium	18	18	18	17	17	17
Sports & Movies Mix	premium	25	25	25	24	24	24
Basic+Movies+Sports	premium	41	42	43	43	44	45 ('Sky World' pack)
Sky HD	service	10	10	10	10	10	10
Chelsea TV	a la carte	6	6	6	6	6	6
MUTV	a la carte	6	6	6	6	6	6
Disney Cinemagic	a la carte	5	5	5	5	5	5
Disney Cinemagic +1	a la carte	5	5	5	5	5	5

Source: Screen Digest from Sky (April 2007)

8 Free-to-air TV

8.1 Key findings

- **Market status:** film transmissions on the five major channels have declined in the last decade. Digital channels transmitting films have, however, increased the number of potential outlets.
- **Value chain:** the UK is unusual in that studio revenues from sales to pay TV are higher than to free TV.
- **Strategy:** although blockbuster films can deliver mass audiences, broadcasters are highly selective in acquiring first-run US titles. In comparison with other genres of programming, films are not seen as cost-effective. Pricing is typically defined by the UK box office.
- **Movie window:** the free-TV window starts 24 to 27 months after cinema release, but is much shorter for independent films.
- **Studio revenues** from the sale of films to free TV were an estimated £199m in 2006.

8.2 Overview, general terms

395. All of the five major analogue terrestrial channels in the UK broadcast feature films. Films still offer a way of generating large audiences with big-budget, star-driven content or with tried and trusted “classics”. The growth of digital TV has increased the number of outlets for feature films on free-to-air TV, often on spin-off channels launched by the main broadcasters.

396. The UK is no exception to an international trend: ratings for films have suffered from audience fragmentation, together with the widespread availability of films on premium channels and low-cost DVDs. Ofcom’s own analysis (in the latest Public Service Broadcasting report) indicates that peak viewing share of films on the five main channels fell from 9 per cent in 2002 to 6 per cent in 2006. Live sports and reality

series are often more cost-effective tools in the scheduler’s armoury.

397. In most European countries, the licensing of films to free TV remains more lucrative for the studios than pay TV. In the UK it is the other way around, because of the existence of a mature pay TV platform in BSkyB makes this market proportionately greater.

398. ITV is rumoured to be planning the launch of a free-to-air film channel to replace ITV Play. This development would further reinforce the trend towards more films airing on free TV despite their decline on the analogue free channels.

General terms with studios – Free-to-air window

399. Free-to-air broadcasters in the UK have historically been reluctant to enter into output

agreements with Hollywood Studios, in particular agreements which bundle together rights to feature films and TV series.

400. The launch of Channel Five in 1997 (with a movie scheduled at 9pm every night) and the development of cable and satellite, have made long-term feature film supply agreements between studios and UK broadcasters more common. Broadcasters still tend to be eclectic, preferring to build packages around specific films and adding tried and trusted library titles where possible.

Terms

401. Unlike pay television, licence periods are not limited to three years. Many run for longer periods of five to six years. The BBC has a rolling output deal with Dreamworks SKG under which it has acquired free-to-air rights for all of its live action films. The term of deals is often determined by the year films are released in the cinema: in other words, the contract will cover all films released in a given year, rather than having a start and end date.

Windows and rights

402. In principle, the free-TV window starts 24 to 27 months after cinema release (i.e. 12 to 15 months after pay TV window). The number of transmissions varies from contract to contract, but is believed generally to be between three and five in a five-year contract. One broadcaster said it aims to get four runs over a five or six-year licence period. Independent distributors may license their films much earlier to free television as a broadcast transmission is likely to have a beneficial effect on DVD sales and rentals due to word of mouth. This could be as soon as 10-11 months after cinema release.

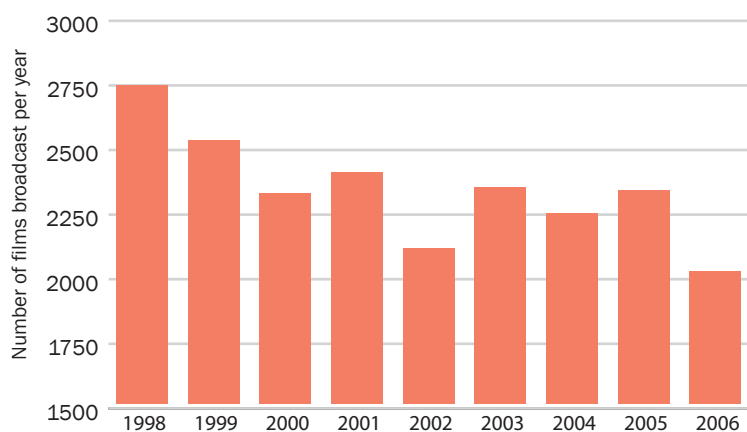
Pricing

403. Pricing is typically based on the UK box office achieved by a particular title. According to distributors, the typical formula is a fee per film of 20 per cent of UK box office. Broadcasters pay a premium for studio product compared to independents. In the case of films which are licensed to free TV before their cinema release, the BBC (and possibly other broadcasters) pay an agreed licence fee but may pay more (or less) depending on box office. Pricing of library films which have already aired on TV may be linked to viewing.

403-1. To summarise, the typical rights deal for a given title include:

- Exclusivity on free-to-air TV starting 24-27 months after release and lasting 3 to 5 years;
- Multiple showings, each additional showing being priced at a discounted rate.

Figure 135: Movies on Free-to-air TV – Total output (top 5 channels)



Total BBC1, BBC2, ITV1, Channel 4, Five.

Source: Screen Digest

Figure 136: Feature film transmissions by the BBC group (2002-2006)

	BBC1	BBC2	BBC3	BBC4	Total
2002/3	828	761	127	303	2,019
2003/4	911	818	172	254	2,155
2004/5	839	964	191	258	2,252
2005/6	654	735	200	199	1,788

Source: BBC Annual Reports

8.3 Market data

Output

404. According to the UK Film Council there were more than 2,700 film screenings per year in 1998 on the five British terrestrial general-interest channels. The number fell dramatically to a little more than 2000 in 2002 and reached 2,200 in 2004. There were 10 movie screenings per broadcaster per week in 1998, and only 8.6 in 2004.

405. More recent figures published by the BBC indicate a decline on both analogue and digital channels. Overall, the BBC aired 231 fewer feature films in 2005/6 than four years before. Film output fell most steeply on BBC1 and BBC4 and actually increased for BBC3.

406. Free television is an important part of the feature film value chain. The UK Film Council noted in its 2002 review that the average audience for a film in peak time was 4.2 million on BBC1 and 4.7 million on ITV, compared to a median audience of two million in the cinema for a top 50 film. Soaps, TV dramas, sports and reality programmes are, however, more likely to feature in the list of top-rated programmes.

407. The top-rated BBC1 film at Christmas 2006 was *Pirates of the Caribbean* with 9.5m; the top film in 2000 was *101 Dalmatians* with 10.1m and in 1999, *Mission Impossible* with 12.8m.

Total revenues

408. Free-to-air television is by definition financed by advertising, and in the BBC case, by the licence fee. It is therefore extremely difficult to relate the revenues of a channel to any particular category of programmes or any given programming slot. Theoretically the audience of commercial breaks occurring before, during and after a movie could give a proxy of the revenues generated specifically by a movie. In fact this would be a poor proxy because:

- The link between audience and net advertising revenue is almost impossible to make for a given ad break because of the discount rate applied on rate cards tariffs, that can vary considerably.
- More fundamentally, advertising is not sold by the spot but by packages of audience.
- The impact of a movie would need to be compared to the average performance of other programme in the same schedule or at the same time on other channels.
- The impact of a given programme is not limited to its direct audience. A strong programme for instance usually boosts the audience of the previous and the next programme too.

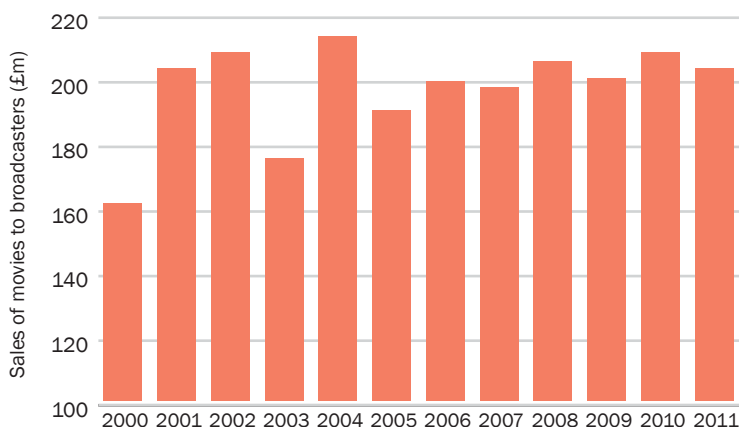
409. For all these reasons, we decided not to try to estimate the advertising revenue 'specifically' generated by movies in this study.

410. In fact, movies today are mostly considered as 'loss-leaders' from the point of view of broadcasters. It is generally accepted that if 'direct' profitability was to be measured by the method suggested above, it would be among the lowest of all programme categories. TV drama and reality shows, in particular, would show much better profitability.

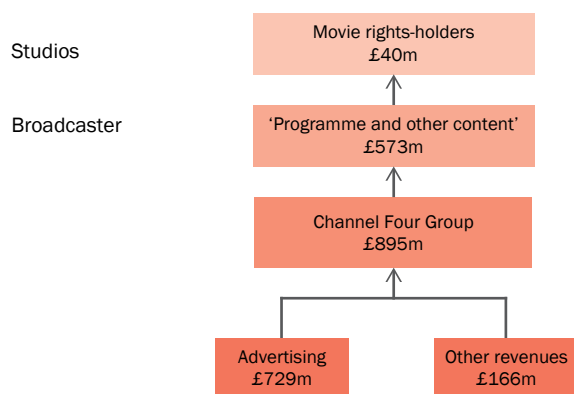
410-1. That explains the double trend observed over the last few years:

- Fewer movies on general-interest channels
- Payments per movie that tend to stagnate or go down but remain high in comparison to ratings, because movies – especially blockbusters – still have a strong appeal that is needed to raise the profile of a channel, whatever audience is actually reached when the movie is broadcast.

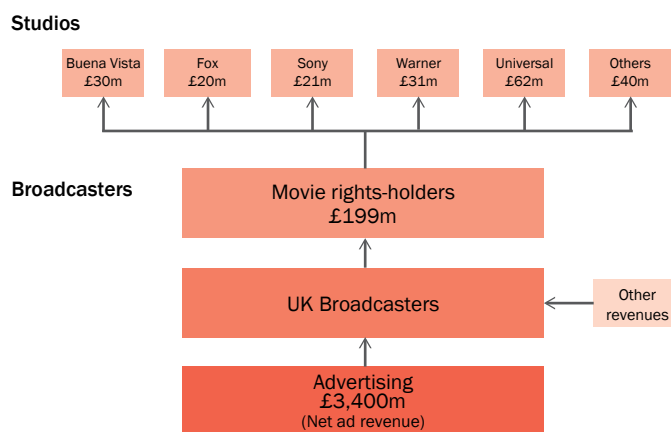
Figure 137: Movies on to basic/free-to-air TV - Studio revenues



Source: Screen Digest analysis of BVA data

Figure 140: Movies on FTA TV – Channel Four Group (2005)

Source: Screen Digest

Figure 138: Free-to-air TV – Cash Flow Chain 2006

Source: Screen Digest

Figure 139: Free-to-air TV – Studio Market Shares 2001-2007

£m	2001	2002	2003	2004	2005	2006	2007	2008
Buena Vista	46.0	49.5	26.1	33.9	52.6	30.5	26.9	33.5
Sony Entertainment	12.1	28.6	16.5	27.5	19.2	21.0	14.3	35.1
Twentieth Century-Fox	30.9	22.2	16.5	39.6	17.6	22.5	30.5	45.2
Warner Brothers	25.3	16.9	30.3	33.9	21.0	30.9	38.0	17.4
Universal + Paramount	45.4	60.9	58.6	27.9	45.0	62.6	61.5	40.0
Entertainment	12.4	9.7	17.9	37.0	29.2	16.6	19.5	17.2
Icon	0.6	6.4	6.7	2.0	1.4	4.8	:	1.7
Momentum	:	:	4.6	4.2	2.8	4.6	4.0	4.9
Pathe	7.5	15.8	3.9	4.8	4.0	5.9	7.1	6.9
LionsGate UK	7.9	4.2	:	:	1.4	2.3	:	5.2
Tartan Films	:	:	:	:	1.0	1.1	:	0.4
Optimum	:	:	:	:	0.6	2.3	1.3	0.9
Others	21.2	5.4	4.4	8.9	4.0	4.8	6.5	6.4

Source: Screen Digest

Studio revenues

411. We estimate that sales of feature films rights to free TV in the UK were £199m in 2006. Our estimates and forecasts are based on cinema box office performances and link the expenditure of broadcasters on film rights to the number of television homes in the UK, and we have made the assumption that spending stays at broadly the same level per household from 2007 onwards.

412. To estimate studio market shares from FTA/basic TV, we have taken the theatrical market share achieved two years before the year in question as a measure. This is an acceptable proxy because movie rights values are based on the performance of films in the theatrical window.

8.4 Principal providers

BBC

413. The BBC acquires films for its two main analogue channels, BBC1 and BBC2, and its digital channels BBC3 and BBC4.

414. The BBC has a long-running output arrangement with Dreamworks SKG which has run from the launch of the studio. The BBC takes free-to-air rights to all of the studio's live action output of 6-8 films a year. In October 2003, the BBC announced a deal with Buena Vista International Television

for rights to a package of over 100 film titles. Feature films included *Chicago*, *Calendar Girls* and *Pirates of the Caribbean*. The package included library titles like *The English Patient* and *Rebecca*. The films were broadcast from the end of 2004.

ITV

415. ITV plc shows films on its flagship analogue channel ITV1 and on digital channels ITV2, ITV3 and ITV4. ITV currently has two

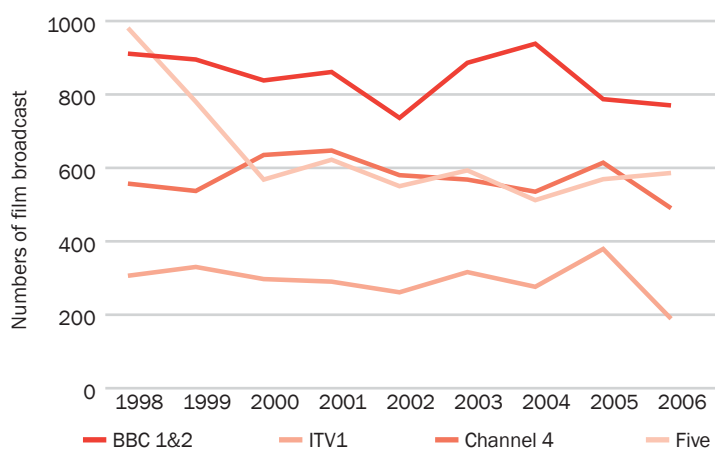
major agreements with US Studios: Warner Brothers and NBC Universal. In September 2004, ITV entered into an “exclusive licensing agreement” with Warner Brothers for free-to-air rights to feature films. The deal gives ITV access to the studio’s 2003, 2004 and 2005 film releases in the UK. Key titles included the *Harry Potter* series of films and library titles were included. ITV’s agreement with NBC Universal was renewed in January 2005. It includes feature films and TV series. The deal includes the studio’s 2004-2006 film output, including productions by Working Title films (such as *Love, Actually*).

Channel 4

416. Channel 4 Broadcasting acquires films for its terrestrial channel and for Film Four, which is now advertising-supported and available to all digital homes in the UK.

417. In March 2006, Channel 4 signed a multi-year deal with Twentieth Century-Fox which the Studio said was the largest ever it had completed with a UK broadcaster. The agreement includes new films such as *Dodgeball*, *The Day After Tomorrow*, *X-Men 3* and *The Omen 666* as well as the library and will run until 2008.

Figure 142: Movies on Free TV – Numbers of film broadcast (1998-2006)



Source: Screen Digest

Figure 143: Movies on FTA TV – Examples of recent Studio deals

broadcaster	studio	deal form	term
BBC	Buena Vista Intl. Television	package	From 2004
BBC	Dreamworks SKG	output deal	Continuing
ITV	Universal	volume deal	2000-2007
ITV	Warner Bros	output deal	2004-2006
Channel 4	Twentieth Century-Fox	n/a	2006-2008
Five	Warner Bros	volume deal	2002-2007
Five	Sony Pictures Intl. Television	n/a	2006-2010

Source: Screen Digest from company report and interviews

Figure 141: Movies on Free TV – Numbers of film broadcast (1998-2006)

	1998	1999	2000	2001	2002	2003	2004	2005	2006
BBC1	449	394	319	339	342	432	434	356	367
BBC2	456	495	513	516	388	448	498	425	397
BBC1&2	905	889	832	855	730	880	932	781	764
ITV1	300	324	291	284	255	310	270	373	183
Channel 4	975	774	562	616	544	587	506	563	580
Five	551	531	629	641	574	562	529	608	484
Total	2,731	2,518	2,314	2,396	2,103	2,339	2,237	2,325	2,011

Source: UK Film Council

418. In 2005 the Channel 4 Group spent £573m on programming, including £499m on Channel 4. Feature Film costs were £35m for Channel 4.

Five

419. Five shows the largest number of films of the terrestrial broadcasters. The company launched two digital channels in 2006 which show some films and TV movies.

420. Five has been the main free-to-air customer of Sony Pictures TV International. The current agreement was announced in October 2006 and is an output deal embracing the Studio's full slate of feature film releases from 2006 to 2008.

420-1. To reduce the cost of film acquisitions, Five has acquired many films on a 'second run' basis, i.e. after another broadcaster acquired the first run. Five has also financed its Sony acquisitions through barter – in other words giving the Studio commercial airtime in place of cash.

Other channels

421. Digital free-to-air and basic pay TV channels (e.g. Bravo, Hallmark, Zone Horror and True Movies) can obtain free-to-air window rights despite the fact that a basic subscription fee may be charged to receive the channels. They are considered by studios commercially as competing in the same window as 'terrestrial' channels. Theoretically they could therefore buy first-run rights but in practice they generally cannot afford to bid for first-run rights of blockbusters as they cannot recoup the huge investment with advertising revenues from a large audience basis as ITV1 or Channel 4 can.

421-1. Distributors define the licensing of films to basic cable channels as falling within the same window as free-to-air television. Due to their much wider distribution and therefore larger audience, free-to-air channels would clearly be expected to pay a higher licence fee than basic cable channels, and would generally take shorter runs and a lesser amount of transmissions.

421-2. The status of Turner Classic Movies is slightly different because it programmes films owned by its parent company Turner Broadcasting. Although the channel would clearly pay a licence fee, it can be assumed that it would have first refusal over any rights being made available to the UK. TCM shows mostly second-run and library movies, not only from its parent company Time Warner, but also from MGM, Studio Canal (European and British classics) etc.

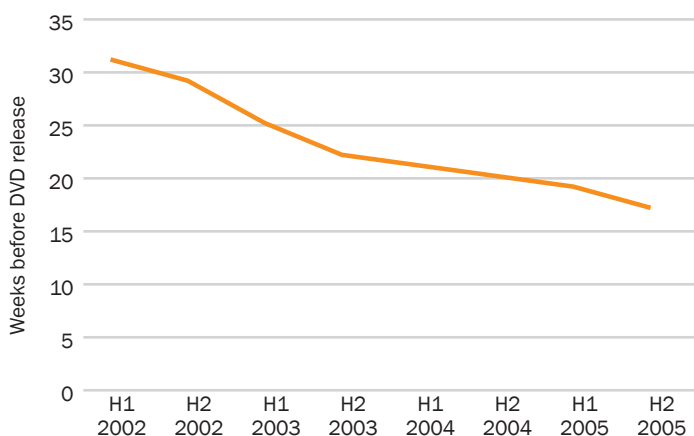
Figure 144: Movies on FTA TV –Proportion of British films

Channel	Number of film slots	Number of UK film slots	Recent UK (ie released since 1999)	% of total film slots
BBC1	367	80	30	8.2
BBC2	397	103	20	5
ITV1	183	38	9	4.9
Ch 4	580	181	42	7.2
Five	484	36	4	0.8
Total	2,011	438	105	5.2

Source: UK Film Council

9 Horizontal focuses

Figure 146: Minimum length of the theatrical window



Source: Screen Digest analysis

Figure 145: Sequential Windows – Starting points

	Window starting
Theatrical release (cinema)	0
DVD rental (high street or online)	4 months (17 weeks)
DVD retail (high street, online, digital)	4 months (17 weeks)
VOD (nVOD or true VOD)	7.5 months
Internet-based download	7.5 months
Pay TV subscription channels	12 to 18 months
Free to view channels	24 to 27 months

Source: Screen Digest

9.1 Release windows

'Theatrical' window

422. The minimum window between cinema and DVD release is currently around 17 weeks (105 days).

423. The theatrical-to-DVD window has declined steadily in recent years, falling from an average 31.1 weeks in 2002 to an average 19.8 weeks in 2005. This decrease led to exhibitors and distributors agreeing a mutually acceptable 17 weeks (four months) as the shortest time period for the window. It is interesting to note that this drop in the window has coincided with a trend that has seen box office become concentrated in the early weeks of a film's release.

423-1. In 2005, a film was taking an average 44 per cent of its overall gross in the first week and 99 per cent in the first eight weeks, compared with 18 per cent and 87 per cent respectively in 1990. The current minimum of 17 weeks is therefore very close to the lower limit of acceptability for exhibitors.

424. This informal minimum window was established recently following an industry disagreement over an attempt by Twentieth Century-Fox to shorten the theatrical-to-DVD window to three months (97 days) for one of its titles, well below the accepted norm of four months. Night at the Museum was still playing at cinemas when the Studio announced the proposed DVD release date, leading a number

of cinema circuits (Vue, Cineworld, Odeon UCI and Showcase) to pull the movie.

425. Fox stated that the title's release schedule was a one-off, based on seasonality due to an early Easter. It is possible however, that these are trial attempts to reduce the theatrical-to-DVD window, designed to test the reaction of cinema exhibitors and to establish the impact on revenues in both windows.

426. There have been various discussions surrounding the viability of simultaneous releasing, or the removal of all windows across all platforms. This scenario would see a film released theatrically, at the same time as a DVD, VOD and even TV release. There were several early attempts at simultaneous releasing in the UK and US, mainly using independent films, although the early results show this was not particularly conducive to cinemagoing.

426-1. In the US, 2929 Entertainment distributed *Bubble*, a movie from director/producer Steven Soderbergh, as a simultaneous release. The film took over \$5m in its first weekend, of which just \$72,000 came from 32 cinema screens (which is not comparable to higher budget Soderbergh titles

but respectable for a micro-budget indie film with no stars), as well as \$5m in DVD pre-orders and other revenues. DVD reportedly accounted for half of the title's revenues, with \$250,000 attributed to a television licence fee from HDNet. The film cost \$900,000 to produce.

426-2. The following table offers a comparison of the arguments for and against simultaneous release.

Video rental window

427. Video rental is no longer assigned its own window, instead titles are released for rental day and date with their retail release.

428. Historically, in the days of VHS, titles were available for rental about six months after their theatrical debut and up to six months before they were released for retail. However, following the launch of DVD and the explosion in retail spending, distributors opted to forgo an exclusive rental window and to bring the retail window and its huge revenues forward.

429. Between mid 2002 and late 2003, all the major Studios effectively abolished the rental window and began releasing titles for retail and rental simultaneously.

430. Initially, this provoked a backlash from rentailers, who considered the higher prices that they paid distributors for rental product to be a trade-off for a ring-fenced period of exploitation. Nonetheless, distributors weathered the storm, and in most cases titles are now released to both rental and retail DVD simultaneously.

430-1. There are occasionally exceptions to the rule, mostly independent titles, where distributors will impose a rental window in an effort to squeeze maximum revenues

Figure 147: UK movie windows – Comparison US/UK

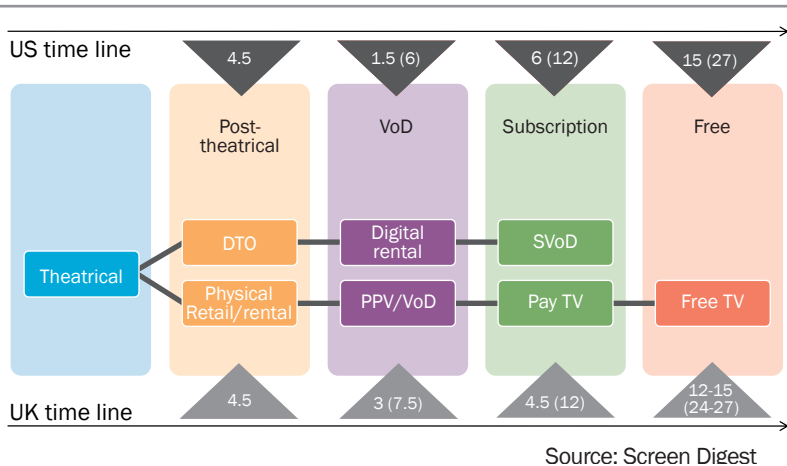


Figure 148: Simultaneous releases issue – Classic pros and cons

Pros	Cons
Economies of scales on marketing costs (rather than sequential marketing campaign at each window launch).	Sequential launches optimise the marketing approach for each film in each window.
Faster return on investment for studios and producers.	Simultaneous releases would threaten the theatrical window which builds long-lasting momentum and legitimacy for a movie.
Reduce online/offline piracy by squeezing the time window for pirate copies to circulate.	Simultaneous releases across products would also entail simultaneous international release and disrupt traditional local practices.

Source: Screen Digest

from rental before releasing it for retail. This strategy is evidently not especially fruitful though, as few choose to adopt it.

'Digital' windows

431. As current technology stands, this means that a film premieres first in the cinema (the theatrical window), then makes its way onto DVD and VHS video (the video window), before progressing onto television – first on PPV and subscription television (the pay TV window), then onto FTA television (see figure below).

432. New 'digital' platforms are sharing release windows with the traditional distribution channels with which they share characteristics:

- Digital retail (download-to-own) is simultaneous with DVD retail
- Online digital rental/VOD/PPV is simultaneous with traditional TV-based nVOD
- Digital rental sVOD is being set at the same time as Premium pay TV as a defensive move from pay TV operators (namely BSkyB) who tend to acquire and hold these rights.

'Second and third' pay TV windows

433. BSkyB buys exclusive premium TV rights and there are no second or third pay TV windows in the UK.

434. In the UK the window that follows premium pay TV, is shared between free-to-air terrestrial TV and 'basic' cabsat channels.

There is no specific window in-between to accommodate pay/premium movies.

435. Multiple pay TV windows were an issue in France when TPS launched a premium channel to compete with Canal Plus, and tried to secure an exclusive second premium window coming after the Canal Plus window and before free-to-air. This is no longer an issue since the Canal+/TPS merger. Canal+ is understood to be currently re-negotiating all Studio deals and trying to obtain 20 to 30 per cent discounts, leveraging its strong position on the Pay-TV market.

Studio-direct-to-retail

436. The studio-to-vendor-to-consumer model underpins all of the platforms assessed in this report. However, with the arrival of new distribution platforms such as Internet VOD there is an opportunity for studios to cut out the middle man and deal with the consumer directly.

437. There is a historical precedent for such a scenario of course - the movie industry was originally a vertically integrated business, with cinema chains in the US owned by the respective major Studios until the Hollywood Antitrust Case in 1948 (see paragraph 503 for further details). However, in the years since then, Studios have opted to distribute their content via specialised vendors, be they exhibitors, video retailers, or broadcasters.

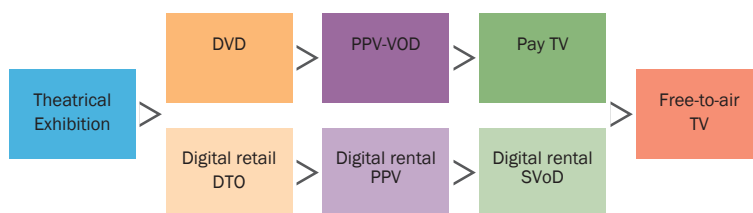
438. Given that emerging digital distribution channels do not require the kind of infrastructure necessary for a physical fulfilment business, they offer Studios a chance to circumnavigate the vendor and establish a direct link with consumers. In the US, the major Studios have already made a foray into the Internet VOD market with Movielink.

439. The service was launched in 2002 as a joint venture involving NBC Universal, Paramount, Sony, Warner and MGM. It offers around 2,000 movies on a digital rental and retail basis, with download-to-burn available for selected titles. However, the service has failed to secure a significant share of the emerging Internet VOD market in the US. According to the NPD Group, Movielink accounted for just three per cent of the market in the third quarter of 2006, compared with iTunes' 90 per cent share. Its Studio owners subsequently sold the company to

Figure 149: Traditional sequential windows



Figure 150: Digital distribution reflecting existing windows



Source: Screen Digest

Blockbuster in September 2007. The terms of the deal were not disclosed but the acquisition reportedly cost the rental giant \$20m.

440. This could signal the end of any studio-direct-to-retail model, for the Hollywood majors at least. The disappointing performance of Movielink means they are unlikely to collaborate on a similar service going forward, and single-studio services would not work in the long term because the limitations of content library would mean that it could not compete with services offering titles from various studios.

441. There may be potential for independents to explore direct-to-retail on a smaller scale than the likes of Movielink, but such services might struggle for exposure in a crowded marketplace. And for the likes of the BBC and Channel 4, which are both developing digital strategies, movies are likely to represent a small proportion of online business.

9.2 Mobile movie market

442. Movies for mobile phones can be delivered in three ways:

Unicast: delivery over the air (OTA) to a mobile phone via the mobile phone network
Broadcast: delivery over the air (OTA) to a mobile phone via a broadcast network

Sideloaded: local delivery through Bluetooth, via a connection to a PC, or through a physical medium

Mobile OTA technology overview

443. Glossary of mobile TV technologies
DAB-IP: Digital audio broadcasting - internet protocol. This standard allows for the broadcast of data over a DAB network. This data can be a video stream, allowing mobile TV services to launch. BT Movio have launched a DAB-IP mobile TV service in the UK.

DMB: Digital multimedia broadcasting. A digital transmission system for broadcasting TV, radio and data to mobile devices, DMB is based on the Eureka 147 DAB standard. DMB services can be delivered over a DAB network with little modification. DMB is used for commercial mobile TV services in South Korea and Germany.

DVB-H: Digital video broadcasting - handheld. This technology is based on the digital terrestrial TV standard, DVB-T, but is optimised for delivery to mobile devices, such as mobile phones. The frequencies which will be released following the switch off of analogue TV services are suitable for DVB-H broadcasting. DVB-H services have launched commercially in Italy and South Africa.

HSDPA: High speed downlink packet access. This is the most widely deployed version of a number of technologies known collectively as 3.5G. 3G allows fast internet access for mobile phones, and 3.5G technologies allow faster speeds using the same frequency and very similar network technologies. This allows mobile network operators to deploy 3.5G quickly and at low cost.

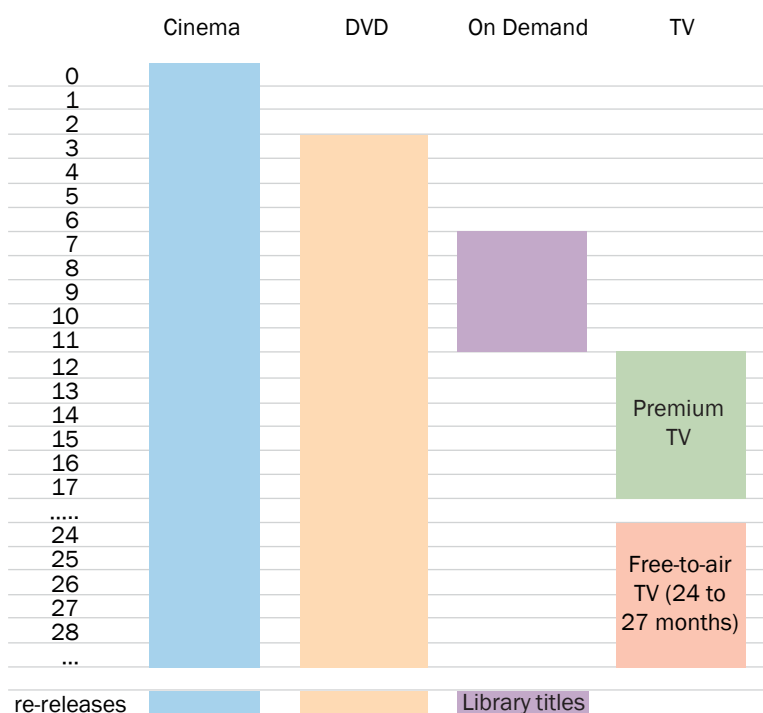
ISDB: Integrated services digital broadcasting. The Japanese standard for digital TV services is also suitable for mobile TV broadcast. It is unlikely to be deployed outside Japan, although there have been some trials in South America. Free-to-air mobile TV services using this technology have launched in Japan.

MediaFLO: Media forward link only. Qualcomm's proprietary mobile TV standard. MediaFLO is very similar in practical terms to DVB-H. Commercial MediaFLO services have launched in the USA.

Unicast

444. Mobile video delivered OTA through the mobile phone network (unicast) is the main delivery mechanism currently used for video

Figure 151: Summarising movie windows in the UK



Source: Screen Digest

in the UK. All UK mobile operators have launched 3G networks, but so far only one (Virgin Mobile) offers a broadcast network. Video can be transmitted over 2G, 2.5G or 3G networks, though the amount of time required to download a clip over a 2G connection would severely test the patience of users. 2G connections are, in practice, typically slower than fixed line dial up, 2.5G typically slightly faster than dial up, and 3G approximately half way between dial up and fixed line broadband.

445. Generally, operators only promote such services to 3G subscribers. Other than video player software or hardware in the phone, no special equipment is required. Most modern phones with colour screens have a video player built in, and in 2006, 70 per cent of handsets shipped featured video players. All 3G phones have video player software.

446. Mobile TV services over 3G networks have already launched worldwide, and have been available in the UK since mid-2005. 3G phones can access a video stream, which can include live programming and movies, but each connection is one-to-one in nature ('unicast') rather than being a one-to-many broadcast. An issue with providing programming in this way is the finite capacity of 3G networks.

447. Although individual networks vary, the generally accepted figure is enough bandwidth is available on a typical 3G transmitter to allow around seven people to watch TV. In rural areas, cells can be 3km apart, although in cities they can be spaced as close as 200m from each other. Having a maximum of seven viewers in an up-to-3km radius severely hinders the potential market.

448. In the UK, if all of the 52,000 or so base stations were 3G this would mean a maximum of 364,000 simultaneous viewers – assuming those viewers were spaced equally around the UK. With those viewers using up the entire bandwidth of the network, no other users could access content or do anything other than voice calls – hardly an ideal situation in a market with 7.8m 3G subscribers at the end of 2006. The next generation of networks (there are a number of technologies, HSDPA currently being deployed in the UK, collectively known as 3.5G) could allow up to 10 times as many users, thus solving the problem but at some cost to mobile network operators to deploy the new technology.

449. 3G offers some advantages over broadcast technologies. As a data network, 3G services have a 'return path'. The user can not only receive data, but can also transmit requests back to the network. This allows interactive TV (iTV) services to launch over 3G networks. Ultimately, Screen Digest predicts that 3G (and its successors) will be the delivery mechanism for niche mobile video viewing, with broadcast being used for mass market programming.

Broadcast

450. The mobile TV broadcast market, over which video can be delivered, is considerably more complicated, with different technologies affecting business models and the battle lines being drawn in a technology war. Acronyms are the order of the day. The major technologies are DVB-H, DMB, ISDB, and MediaFLO. Mobile TV broadcast services are live in the UK (DAB-IP), Germany (T-DMB), Italy (DVB-H), Japan (ISDB), South Korea (T-DMB and S-DMB) and the USA (MediaFLO) with trials ongoing in virtually every other developed country.

451. BT Movio launched its DAB-IP service in conjunction with Virgin Mobile in the UK in late 2006. DVB-H is likely to be the other major technology used for mobile TV broadcast in the UK. However, such services are unlikely to launch until 2008 at the earliest, when analogue TV services will begin to be switched off. It will not be until 2012 that the frequency currently used by analogue TV will be available for the entire country.

452. There is no 'return path' for either DMB or DVB-H, so interactive TV is not possible without some additional communication channel. The natural conduit for this would be through the mobile phone network, but if a company other than a mobile operator was to run a mobile broadcast service, business and integration issues could effectively rule iTV services out.

453. Personal video recorder (PVR) mobile phones have launched in the UK, and allow users to download video as it is broadcast over the network. Although not exactly 'on demand' as the video is not delivered the instant the user requests it, this mechanism does allow for a 'semi-VoD' service. Screen Digest expects this type of service to be used

initially for event driven services, such as clips from football matches or music concerts. Due to the nature of the mobile device, with users typically moving in and out of reception areas, there are technical challenges for delivering longer content such as movies.

Hybrid technologies

454. There are a number of technologies which could be described as a hybrid of unicast and broadcast. MBMS (multimedia broadcast multicast service), CMB (cell multimedia broadcast) and TDtv (time division TV) all work in a broadly similar fashion. In effect, some of the 3G spectrum is reserved for 'multicasting' TV, creating a one-to-many connection where devices 'listen' and data is only transferred one way. This overcomes the bandwidth limitations of 3G.

455. However, in return, this portion of the bandwidth cannot be used for conventional point-to-point communications and so a trade-off is made. The overall capacity of the network is reduced in exchange for allowing, in effect, an infinite number of viewers of a TV stream. While these have been trialled, there are no current plans for deployment in Europe.

Current OTA services

456. Although there are numerous 3G TV services, none specifically feature movie content.

457. While a Sky Movies channel is available as part of the Sky content on offer, this channel does not, in fact, show movies. Movie clips and trailers make up the bulk of the programming.

458. ITV and BBC channels are part of the Virgin and 3 services, along with Channel 4 on the Virgin service. Since these are all simulcast of the terrestrial channels, movies will form

part of the offering. There are no movie-specific channels currently available.

459. Short films have long formed part of video-on-demand services and the mobile platform has provided a boost to this content category. Orange and Nokia have both sponsored short film festivals and prizes, and there are now several specifically mobile short film festivals and prizes, such as CellFlix and The4thScreen. The Sundance Film Festival also has an initiative to fund development of short films for mobile, with several high profile names (including festival chairman Robert Redford) involved. This media is typically delivered as pay-per-download individual VOD transaction, rather than as part of a scheduled TV service.

460. Movie-specific services have launched in North America. mSpot runs pay per view movie services for a number of network operators including Sprint in the US and Bell Canada. Sprint's mSpot Movies uses both subscription and rental models. Subscription is priced at \$6.95 a month offers for all-you-can-eat movie selections. Sprint says mSpot Movies has been seeing growth rates of 30 per cent per month, indicating strong customer demand for mobile movie and entertainment options.

461. However, a lot of subscriptions are given away free to promote the service. Sprint Movies bought by the rental model costs between \$3.98 and \$4.99 apiece; users are able to view the movie unlimited times with rental periods which range from 24 hours to one week, depending on the title. Users who rent 24-hour titles can get up to two 24-hour extensions for \$0.99 each. Users can watch an entire movie all at once, or play, pause, resume, and chapter-skip in a manner similar to standard DVD players.

462. Sprint Movies is only compatible with 3G handsets. Movie selections have been edited,

Figure 152: Mobile TV services in the UK

service	operator	technology	content provider	channels
Planet 3 TV	3	3G	mobiTV, Sky, ITV, BBC	29
Orange World TV	Orange	3G	mobiTV, Sky	26
Vodafone Live! TV	Vodafone	3G	Nunet, Sky	34
ROK TV	All	2.5G	ROK TV	21
Virgin Mobile TV	Virgin	DAB-IP	BT Movio, Arqiva	5

Source: Screen Digest

if necessary, to meet TV-14 ratings standards. mSpot has content deals with Buena Vista, Lionsgate, Sony Pictures, and Universal.

Sideloading

463. Sideloading is typically delivery over the Internet to a PC, followed by loading the content onto a portable device. Devices capable of receiving content in this way include high end mobile phones, video iPods and the Sony PSP. The only service to have launched specifically selling content optimised for these mobile devices is Apple's iTunes store, and none are selling content specifically for mobile phones.

464. Many mobile phones now use memory cards for storing content, and over the last two years a number of companies have been offering movies distributed in this fashion. Initial sales were disappointing (in the hundreds for the UK market) and many companies switched to offering movies on memory cards as a 'value add'. With memory cards becoming a commodity, some manufacturers attempted to sell cards with pre-loaded movies, often with no price premium relative to blank cards. What some retailers have reported is that sales of these cards are actually lower than equivalently priced blank cards. Screen Digest does not expect this to be a popular method of distributing mobile content.

465. Bluetooth has also been used for distribution of content. Typically this is free content such as movie trailers; for example, a number of Bluetooth enabled advertisements can be found dotted about the London Underground system. A handful of retailers

are also experimenting with in-store kiosks distributing paid-for content. No results have been made public.

9.3 High Definition

Introduction

466. 'HD' refers to High Definition quality, as opposed to traditional Standard Definition (SD). It means the picture has a resolution of at least 720 vertical lines, widescreen ('Full HD' being 1080 lines).

466-1. HD is not a new product but a technical improvement affecting all levels of the technical chains and audiovisual markets. This includes:

- all movie media/markets/products (FTA, pay TV, VOD, physical video formats)
- all video consumer electronics products (displays, STBs, players, game consoles, camcorders etc.)
- all audiovisual content and genres (not only movies but sport, TV series, music etc.).

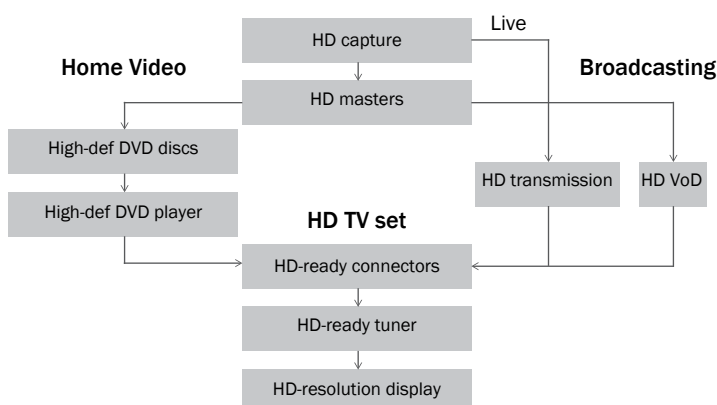
466-2. HD will affect the competition between movie markets, specifically broadcast television and home video. Picture and sound quality are an important element in the long-term competition between television (free and pay) and home video as a source of movie entertainment in the home.

466-3. Packaged home video has challenged television as a prominent source of movie-watching since inception (VHS in the early 1980s). DVD was so successful because of the leap in picture and sound quality compared to the experience on television and VHS.

466-4. HDTV is now allowing television – and particularly Premium Movie Channels – to catch up with the DVD experience in terms of picture quality. Actually the combination of HDTV service and a PVR, or HD-quality VOD, are now both good substitutes for the DVD experience for sophisticated consumers.

467. The launch of next-generation, high definition video discs could restore the lead of packaged media however. Indeed high definition video discs and players feature a native 1080p resolution that matches that of the 'Full HD' displays that are now coming

Figure 153: High definition technical chain



Source: Screen Digest

to the market in high-end categories (37" and above).

468. We do not anticipate that this last technical aspect will make much of a difference though because:

- the format battle between HD DVD and Blu-ray Disc is expected to slow the uptake of next-gen players and discs; in the meantime, HD-quality services (Premium Movies channels and VOD) have a window of opportunity
- the leap between 'Normal' HD and 'Full HD' is closer to the limit of visual perception and may be hardly visible to most viewers (but picture quality expectations may be growing in the future as consumers get educated to higher standards).

469. Conversely, because not everyone has access to Sky or is ready to pay for Sky HD, and because there will be very little HD content on free-to-view platforms in the mid-term, there will be a growing frustration from HDTV set owners and that could also create an opportunity for movies on HD-quality packaged media.

High definition video

470. Following developments in HDTV, Europe has seen the launch of hi-def video. HD DVD and Blu-ray Disc (BD) are the principal contenders in this market. There are other hi-def formats, such as VMD from New Media Enterprises. However, HD DVD and BD are the most widely available and have the broadest support from manufacturers and content owners.

Hardware (hi-def players)

470-1. The formats have divided the consumer electronics industry. BD is supported by the majority of Japanese and European companies while HD DVD support comes from Toshiba, Thomson and a number of Chinese consumer electronic companies (such as Ami Electronics and Sichuan Changhong Electric, the two largest Chinese CE manufactures). The weight of hardware manufacturing support behind the BD format would appear to make the outcome of a format war a foregone conclusion; however, the Chinese manufactures proven ability to bring inexpensive hardware to the market will offset some of this initial advantage for BD.

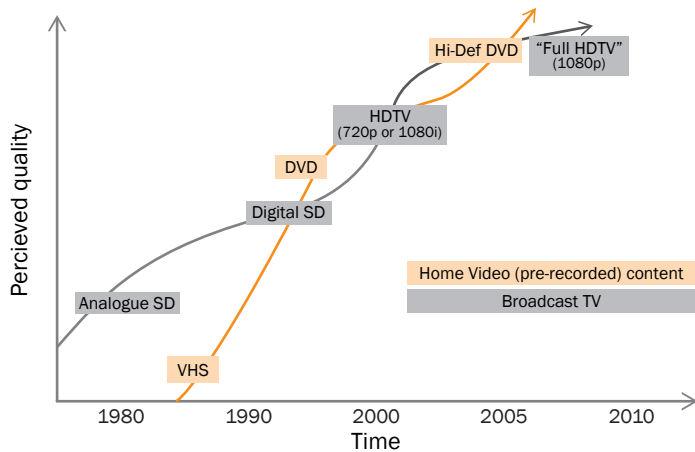
471. Both camps have launched hardware and software in Europe in 2007.

472. The key differences between the hardware offers are that:

- HD DVD players are less expensive than BD
- BD is supported by PlayStation 3 (PS3), which in the US have outsold standalone players by 100 to 1, although the PS3 is seen as a games console rather than a BD player with US owners appearing to be buy relatively few BD movies

473. Since launch, the prices of the first generation hi-def players have fallen. Supporters of both formats have launched lower cost 'entry-level' players in the US (BD

Figure 155: HD affecting competition between TV and home video



Source: Screen Digest

Figure 154: High Definition movies options in the UK today

Market	HD movies	UK-enabled homes
FTA TV	BBC HD on satellite and Virgin Media	About 250,000
Pay TV	2 Movie channels and one nVOD service on Sky HD	
VOD	Some HD-quality films on Virgin on Demand – Some HD-quality movies on Sky Anytime	79,000 V+ HD-compliant subs on Virgin Media
Home Video	600 titles approx. so far in Blu-ray and HD DVD	1.2m

Source: Screen Digest

\$399, HD DVD \$299) and the equivalent European machines are expected during summer 2007. This brings the player prices in to the affordable price bands for wider adoption by a broader cross-section of consumers.

474. The rate of decline in player pricing has been especially rapid compared with DVD and this has led to the expectations of a relatively swift adoption by consumers. However, delayed and un-coordinated product launches led to a less positive initial consumer response. Manufacturers shipped around 15,000 hi-def players (Blu-ray and HD DVD combined) to

Europe in 2006 with just 3,000 (20 per cent) sold through to consumers.

475. Both formats are supported by gaming consoles in addition to players: BD by Sony's PlayStation 3, and HD DVD by Microsoft's Xbox 360, the latter through an external drive. Current pricing makes the purchase of a games console one of the most cost efficient ways for consumers to enter the hi-def video market.

Software (hi-def optical discs)

476. On the software side there is support from the Hollywood majors for both formats. Some have chosen sides, although these allegiances are not necessarily permanent; others have elected to remain 'format agnostic'.

477. Between BD and HD DVD, over 100 hi-def titles have been released in Europe to date (Q1, 2007) with hundreds more to follow throughout 2007. However, sales of software have so far been hampered by the low availability of hardware; at the end of January 2007 cumulative sales of hi-def video in Europe were around 30,000, compared with 660m DVD sales. The UK accounted for 85 per cent of cumulative HD DVD sales over this period and is currently the second largest European market for hi-def overall, behind Germany.

Figure 158: High-definition video - Impact on spending

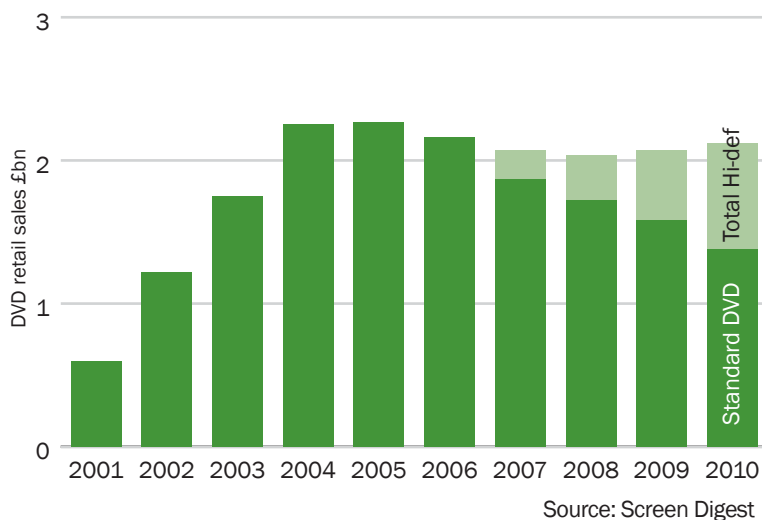


Figure 156: High-definition video - Initial hardware offerings

Format	Device	Launch	Price
BD	Samsung P1000 player	Oct-06	£1,000
BD	Panasonic DMP-BD10 player	Oct-06	£1,000
BD	Sony PS3 (£425)	Mar-06	£425
HD DVD	Microsoft Xbox 360 add-on	Nov-06	£130
HD DVD	Toshiba HD-E1 player	Dec-06	£315
HD DVD	Toshiba HD-XE1	Feb-07	£500

Source: Screen Digest

Figure 157: High-definition video - Studio support of formats

Blu-ray	Both	HD DVD
Sony	Warner	Universal
Disney		Paramount
Fox		
MGM		

Source: Screen Digest

Impact of new formats on video retail

478. Sales of the new hi-def formats in the UK are expected to bolster the declining DVD market in the UK but will not recreate the DVD boom. Consumers, equipped with a hi-def player, are more likely to cherry pick favourite catalogue titles and new releases from those available on hi-def.

478-1. As a result, volume sales of video are unlikely to increase and instead the key benefit of hi-def will be to (re)establish premium prices in a market that has seen DVD prices dramatically eroded over recent years. Providing that the price differential between DVD and hi-def video is maintained, the adoption of hi-def will lead to an uplift in consumer spending. This could boost total retail spending (including non-film) by as much as £700m by 2010. It is worth noting, however, that the current format war will dampen consumer demand for hi-def video.

HD television

479. In the context of broadcast television, HD will not create a new standalone service, as marketing spin can sometimes suggest, but will instead represent a big technical improvement and hopefully marketing tool. It will act as a:

- churn reducer,
- ARPU driver,
- and generate first-mover advantage.

480. HDTV is not going to become another type of television that will co-exist with SDTV to form a separate product, but will grow to the extent that ultimately – somewhere in the 2010s – it will simply become the new standard of television. When it comes to movies, general terms, rights and windows arrangements are not different or separate for HD.

481. When HD movie channels are launched, existing rights deals are simply amended to provide HD masters. We do not believe studios ask for a significant additional cost when delivering an HD master instead of – or in addition to – an SD master. Our understanding is that all major Studios have re-mastered most of their library titles and are now providing new movies with HD masters if requested.

HDTV uptake

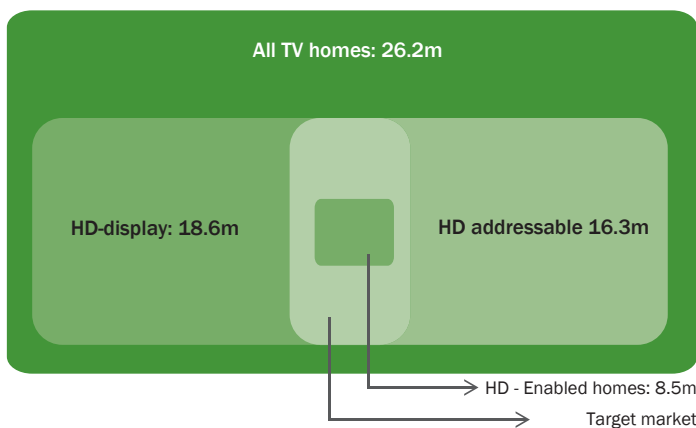
482. Penetration definitions:

- **HD-addressable households:** households connected to a TV platform (satellite, cable, IPTV) and in a region where HD broadcasts are available (whether or not they have the equipment and subscription to actually watch it in HD). For instance, all subscribers to digital satellite and nearly all digital cable subscribers are technically addressable, and some HDTV is available on both platforms in the UK. Analogue cable subscribers are never eligible. Some IPTV subscribers can be eligible but this is dependent on sufficient bandwidth.
- **HD-display households:** households equipped with at least one 'HD ready' TV set (at least 720 horizontal lines, and HDMI input). More than 70 per cent of flat panel televisions sold in the UK are already 'HD ready'.
- Households that are both 'HD-addressable' and 'HD-display' form the 'Target market' from the point of view of HD service providers (pay TV operators in particular). For these consumers to actually be able to watch HDTV they are required to invest in the appropriate equipment.
- **HD-enabled households:** households actually capable of watching broadcast TV or TV-VOD in HD quality (with a suitable HD-capable set-top box and an HD subscription if required, in addition to their 'HD-display')

The Venn diagram shows how those penetration concepts are intertwined.

483. By end of 2006, about 10m UK households were connected to a platform offering HD signals: all the Sky DTH subscribers, most of the Virgin Media subscribers, and a few UK households with free satellite dishes. At that time, almost 3m households were equipped with HD ready TV sets. Of those, only about 200,000 were actually watching HD, which requires getting

Figure 159: HDTV penetration UK 2011



Source: Screen Digest April 2011

Figure 160: HDTV metrics in the UK (2006-2011)

000s households	2006	2007	2008	2009	2010	2011
HD-display HHs	2.857	6.127	9.697	13.240	16.337	18.676
HD-enabled HHs	0.211	0.670	1.687	3.393	5.614	8.569

Source: Screen Digest April 2007

an HD set-top box and an HD subscription from their pay TV operator.

484. At end 2011 we expect HD coverage to reach 16m UK households (all of pay DTH, digital cable and most of IPTV – but only some of DTT) and the HD ready penetration 18m. Because we expect HDTV to remain mostly a pay TV platform in the next five years, we forecast that only 8m households will be watching HD broadcasts on a regular basis.

Movies on High Definition TV

485. Movies, along with documentary and sports, are one of the first types of programming to migrate to HD because:

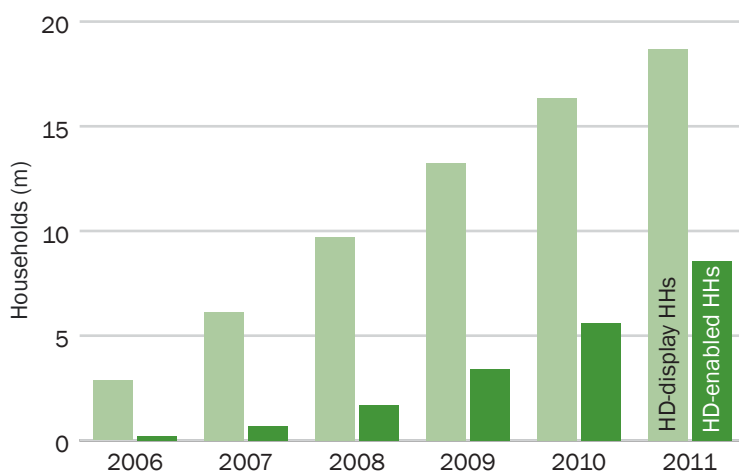
- Picture quality is more important than in other programme genres (as was shown in

the consumer research led during the HD terrestrial trial in London*).

- Movies are traditionally shot in 35mm so it is relatively easy to deliver an HDTV master, either by transferring from existing film material to an HD master, or by shooting with HD-cams instead of film cameras. And there is a huge quantity of 35mm films that can be re-mastered at a reasonable cost – contrary to many other television genres for which the original material is low-res video or 16mm hence generally not suitable for HD.

** HD-quality DTT trial conducted in 2006 in London, in MPEG-4, on 400 selected households, showing content from the BBC, ITV, Channel 4 and Five.*

Figure 161: HDTV uptake in the UK (2006-2011)



Source: Screen Digest April 2007

486. The table below shows the trends in availability of TV programmes in HD in the most advanced markets in Western Europe (including the UK). It is also Screen Digest's view of the share of TV output likely to be available in HD from a TV viewer perspective. It illustrates the pace at which each genre will migrate towards HD. By 2015-2020 we believe HD will have become the new standard for television broadcasting.

487. Sky HD launched in May 2006, giving access to up to 10 channels in HD, including two 'Sky Movies' channels in HD and one nVOD movie service in HD. Only Premium movie subscribers do receive the HD movie channels; only premium sports subscribers receive the HD sports channels.

Figure 162: HDTV – How TV content categories are moving to HD

	2006	2008	2010	2012	2015	2020
Movies						
Landmark documentary						
Major sports events						
Landmark drama						
Live music						
News and factual						
Advertising						
Other local, non-premium TV genres (entertainment, children's programmes, sitcoms, quizzes, etc.)						

Light blue: genre partly produced/broadcast in HD

Dark blue: genre predominantly produced/broadcast in HD

Source: Screen Digest

487-1. Sky HD subscribers have to pay £10 per month in addition to their existing subscription fee. The Sky HD box, which is also a 'Sky+' PVR box, costs £299. At the end of the first quarter of 2007, Sky had already 244,000 subscribers (UK and Ireland). Around 15 per cent of them were new Sky customers and 85 per cent were existing Sky subscribers upgraded to HD. According to BSkyB, Sky HD is the company's most successful new product launch ever – the uptake being faster than Sky+ four years ago. This is all the more remarkable given that the addressable market (Sky subscribers equipped with HD ready television sets) is limited to about 10 per cent of households at the moment.

488. Virgin Media is also giving access to HD programmes on its VOD platform, but the only linear HD channel so far on Virgin Media is BBC HD. So far, Sky Movies HD 1 and 2 as well as Sky Sports HD 1 and 2, Sky Arts HD, and third party channels Discovery HD, National Geographic HD are exclusive to Sky HD DTH. In the competition for differentiation, while cable and IPTV have a technical edge to provide true VOD, satellite has the capacity to provide more bandwidth-hungry HDTV channels.

489. Virgin Media customers equipped with the V+ box (79,000 at end-2006 and 150,000 at end Q1 2007) can also access on demand content in HD quality, including a number of movies (about 30 at the moment). VOD prices typically include a premium cost when content is in HD quality: £4 to £4.50 instead of £3.75.

489-1. Channel Four and ITV have both announced their intention to launch HD channels in early 2008. Channel Four on Demand will also make HD content available on Virgin Media. At least BBC HD and ITV

HD will be present on Freesat at launch in spring 2008.

9.4 Piracy

Introduction

490. All of the movie markets assessed in this report are under threat from piracy, arguably more than ever before. No longer is the black market comprised of sub-standard VHS copies with piecemeal availability. Today consumers can access DVD-quality movies through illegitimate channels, often in advance of a title's video and theatrical release.

491. And piracy is now a two-headed monster, with illegal filesharing over the Internet exacerbating the effects of an already damaging counterfeit video or 'hard goods' piracy trade.

Financial implications

492. According to 'The Cost of Movie Piracy', a study commissioned by the Motion Picture Association (MPA) and prepared by LEK Consulting, the major Studios lost around \$6.1bn (£3.1bn) to piracy worldwide in 2005. The report - which was based on a survey of over 20,000 movie consumers in 22 countries—calculated that up to \$406m (£207m) in potential Studio revenues was lost in the UK in 2005, the second highest loss of all the international markets, behind Mexico. The revenue lost in the UK reportedly equates to 14 per cent of its potential market.

493. At consumer level, the report estimates that piracy in the UK cost the movie industry just over \$1bn (£510m) in potential consumer spending. This loss was not suffered by the Hollywood majors alone, although the report

Figure 163: Piracy – Financial impact of piracy in the UK in 2005

		Internet	Hard Goods	Total
Consumer spending lost to piracy	£m	195	315	510
MPA member company revenues lost to piracy	£m	77	130	207

Source: MPA/LEK Consulting

Figure 164: Piracy – Financial impact of piracy in the UK in 2005 split by majors and independents

		MPA member companies	Independents	Total
Consumer spending lost to piracy	£m	399	111	510

Source: MPA/LEK Consulting

indicated that they accounted for the lion's share of the losses at \$787m (£399m). It was also endured by independent and local producers and distributors. The latter missed out on an estimated \$220m (£111m) in consumer spending in 2005.

494. On a global scale, physical piracy remains the biggest drain on revenues, accounting for 61 per cent of total movie industry losses at \$11.1bn (£5.7bn). Internet piracy – defined in the study as obtaining movies by either downloading them from the Internet without paying or acquiring copies of illegally downloaded movies from friends or family – was responsible for losses of \$7.1bn (£3.6bn) or 39 per cent.

Preventative measures

495. The movie industry has not yet suffered the same fate as the music sector – which was close to collapsing a few years ago as a result of the effects of illegal file sharing – where Internet piracy is concerned. This is due to a number of factors:

- The large size of movie files and a corresponding lack of consumer broadband bandwidth means that downloading a feature film is a prolonged process.
- Those consumers downloading movies illegally come from a much smaller demographic than movie consumers as a whole – the process of filesharing, downloading and burning to DVD is limited to the relatively tech-savvy.
- Consumers' attachment to the physical product is arguably greater for movies than for music with DVD box sets for instance, being more desirable than CDs.
- Music lends itself to portability; it can be consumed in scenarios that movies cannot.

496. However, as bandwidth increases and new compression technologies develop, consumers will be able to download a feature film illegally for free in less than 10 minutes, burning it to DVD if they wish, which makes it a far more attractive proposition. It is therefore essential that the movie industry establishes a legal online distribution infrastructure to offer consumers an alternative to piracy.

497. Meanwhile, the industry is investing in preventative measures. One of the most significant initiatives is anti-piracy research

and development company Motion Picture Laboratories (Movelabs). Hollywood's six major Studios – Disney, Fox, Paramount, Sony, Universal and Warner – are financing the project, with investment expected to reach about \$30m by the end of 2007. Movelabs is responsible for developing a number of anti-piracy tools including:

- network-management technology to prevent illegal file-sharing on computer networks
- online traffic monitoring tools to identify piracy on peer-to-peer sites
- systems to enforce geographical restrictions of content ('geo-blocking')
- devices to detect camcorders in cinemas.

498. The MPA is providing management assistance and acting as technology consultant on the project. Modelled on cable TV think tank Cablelabs, the anti-piracy venture is headed by its own chief executive, reporting directly to the Studios rather than the MPA.

499. There are continued efforts to crack down on the illegal DVD trade, but these tend to be local operations rather than the kind of global initiatives necessary for online piracy.

500. In the UK, the foremost anti-piracy body is the Federation Against Copyright Theft (FACT). Established in 1983, FACT's purpose is to protect the film and broadcasting industry in the UK against counterfeiting, copyright and trademark infringements, primarily in terms of physical piracy but also, increasingly, Internet piracy.

501. Whilst FACT is not a statutory body, it is accepted as a prosecution authority in its own right and facilitates the investigation and prosecution of those involved in this type of crime. It works closely across the UK with Trading Standards, HM Revenue and Customs and the police. Indeed the latter launched a special unit in partnership with FACT in February 2006 dedicated to combating film piracy and the organised criminal networks sustaining the manufacture and distribution of counterfeit video.

9.5 Consumer attitudes to movie products and services

502. Whilst a number of consumer research firms – Taylor Nelson Sofres (TNS) for one – have made it a cornerstone of their business, there are few studies in the public

domain which assess the relationships between different movie distribution channels. That is to say, which measure how platforms substitute and/or complement each other.

503. One such study is the annual Cinema and Video Industry Audience Research (CAVIAR) survey conducted by BRMB Research on behalf of Carlton Screen Advertising. It explores the relationship between cinemagoing and DVD watching.

504. According to the 2006 edition of the survey, 10 per cent of cinemagoers watch DVDs once a month. A much smaller proportion (five per cent) watch DVDs two to three times a year, and just three per cent of cinemagoers watch DVDs less often than that.

505. Most cinemagoers – 26 per cent – watch DVDs once a week according to the CAVIAR

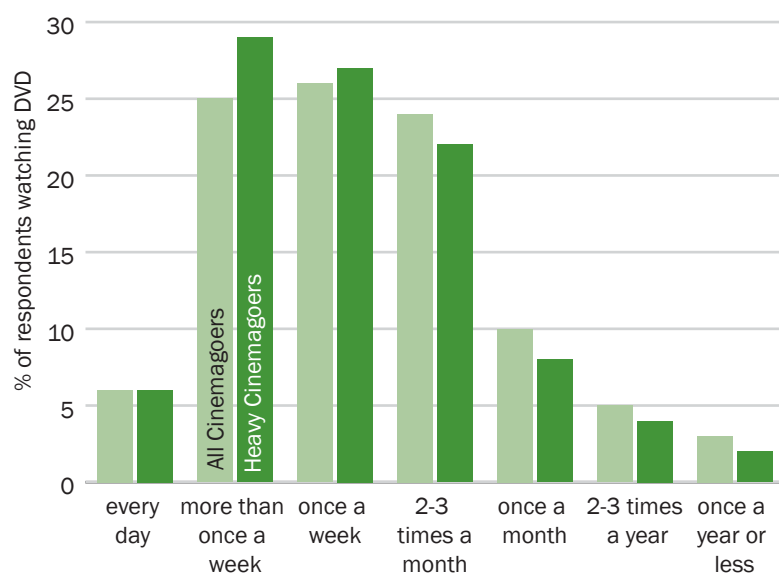
data. And almost as many respondents (25 per cent) watched DVDs more than once a week. This proportion rises to 29 per cent for those respondents which attend the cinema ‘once a month or more’, the so-called ‘heavy cinemagoers’. This trend is visible in other categories – whilst few respondents watch DVDs on a daily basis, heavy cinemagoers are slightly more inclined to do so (seven per cent) compared with all cinemagoers (six per cent). Thus there is evidence in the CAVIAR study of a link between rates of consumption across different distribution channels.

506. This is supported by another study from the Centre National de la Cinématographie (CNC) in France. Based on an online survey conducted by Novatris in October and November 2006 covering 3,761 individuals aged 15 years and over, the study identified a relationship between Internet VOD users and the technologically literate. Whilst this report is focused on the UK market, and this study focuses on France, it is nonetheless interesting to examine its results.

507. The study determined to what degree French consumers have explored the Internet VOD marketplace. According to the research, around two thirds of Internet users in France are aware of the availability of VOD over the open Internet. Of those respondents that were aware of Internet VOD, 29 per cent have already visited a website which offers video content on demand. This translates into 19 per cent of the Internet users assessed. Of these, 24 per cent have actually downloaded video content through such services, but this equates to just four per cent of all Internet users.

508. The survey demonstrates a correlation between respondents’ rates of entertainment consumption through traditional distribution channels and the degree to which they have explored VOD, with the most fervent consumers of content showing a greater inclination to use VOD services. Novatris’ research showed that most Internet users (64 per cent) attend the cinema ‘occasionally’ (at least once a year but less than once a month). However, those that have visited a VOD portal are revealed to be ‘regular’ cinemagoers, with over a third visiting the cinema at least once a month (but less than once a week). This proportion rises to 39 per cent for respondents that have actually downloaded video content, whilst 13 per cent of those that

Figure 166: Consumer attitudes – Cinemagoers DVD viewing behaviour



Source: Screen Digest

Figure 165: Consumer attitudes – Cinemagoers DVD viewing behaviour

		All Cinemagoers	Heavy Cinemagoers
everyday	%	6	6
more than once a week	%	25	29
once a week	%	26	27
2 - 3 times a month	%	24	22
once a month	%	10	8
2 - 3 times a year	%	5	4
once a year or less	%	3	2

Source: CAVIAR

have used a VOD service go to the cinema at least once a week.

509. Similarly, heavy video renters are apparently more likely than 'non-renters' to access video content online. As many as 58 per cent of the Internet users questioned are effectively 'non-renters' (they rent DVDs less than once a year). This relatively high proportion reflects the traditionally weak rental sector in France. However, amongst Internet users that have visited a VOD site there are fewer 'non-renters' (50 per cent), with 16 per cent renting DVDs 'regularly' (at least once a month but less than once a week). This proportion is even greater for Internet users who have already downloaded video content (21 per cent), with a further 12 per cent renting DVDs at least once a week.

510. Only three per cent of the same group buy DVDs weekly, according to the survey, however, those respondents that have used VOD services still emerge as the most avid consumers of retail DVD. When the 'frequent' and 'regular' DVD buying sub-sections are combined for VOD users, it emerges that close to one third of those respondents

purchase DVDs at least monthly compared with 22 per cent of those that have only visited a VOD site and 18 per cent of all Internet users.

9.6 The Long Tail

511. By 'Long Tail', we refer to the concept that a wider array of titles, catering for niche markets, will attract a broader consumer base and create larger revenue opportunities. Library titles can also be exploited economically over a longer period than traditionally, thanks to digital exploitation and the subsequent collapse of variable release costs. The term was forged by journalist Chris Anderson from magazine Wired in 2005 and then developed in his book *The Long Tail*. 512. The 'elastic walls' boasted by online retailers of physical media and digital platforms facilitate a broader range of content to be offered, driving consumption beyond recent blockbusters towards both independent titles and back catalogue.

Cinema

513. The theatrical sector is dominated by first-run releases. In 2006, new releases accounted for a massive 90 per cent of titles distributed theatrically, and over 99 per cent of box office revenues. There were a total of 505 first-run films released in UK cinemas in 2006, while just 52 were re-releases or re-issues.

514. Digital cinema will reduce the fixed technical costs (masters) associated with a re-release and reduce the variable costs to almost nothing (no more prints to manufacture and handle). As a result the output of re-releases is likely to increase significantly (although this may require some public support), especially if independent art-house exhibitors are equipped with digital projectors.

514-1. When digital cinema becomes the new technical paradigm, the share of library movies in admission and revenues will slightly increase

Figure 168: Consumer research - Distribution of Internet users according to frequency of visits to the cinema

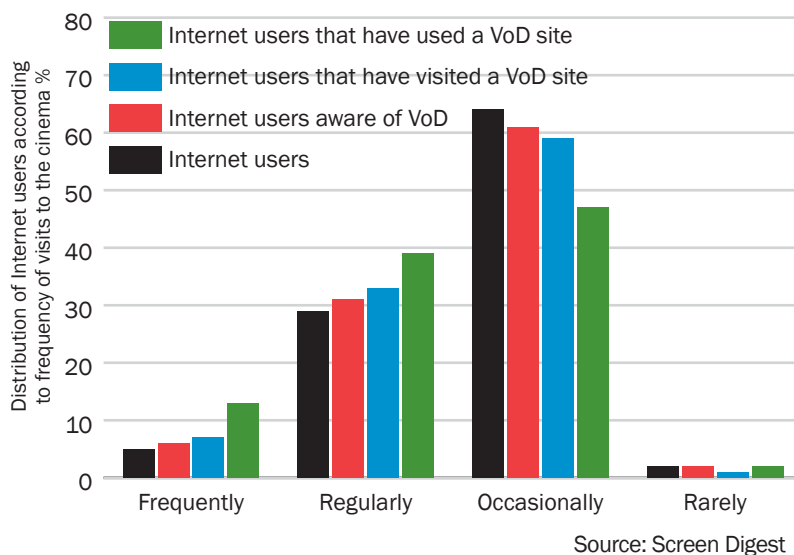


Figure 167: Consumer research - Distribution of Internet users according to frequency of visits to the cinema

		Frequently	Regularly	Occasionally	Rarely
Internet users	%	5	29	64	2
Internet users aware of VoD	%	6	31	61	2
Internet users that have visited a VoD site	%	7	33	59	1
Internet users that have used a VoD site	%	13	39	47	2

Source: CNC/Novatris

but, in any case, cinema exhibition will remain predominantly a novelty-driven window.

DVD rental

515. The arrival of subscription DVD-by-post services has transformed the rental market. Historically very much a new release business, rental is now generating value from catalogue product, independent titles and niche product thanks to the online sector. And whilst this report is concerned with film only, it is worth noting that online DVD rental has also encouraged growth in the rental of non-feature titles, particularly TV DVD.

516. Like etailers, the rentmail players have an advantage over their bricks and mortar

equivalents in that they can offer a much larger library of titles as they have no shelf space or shop floor capacity to consider. It is not feasible to employ the long tail strategy in a rental store stocking no more than around 500 titles, but for the likes of LoveFilm, which boasts some 40,000 titles, it is a viable business model.

517. Indeed, rental transactions for the online services are more broadly distributed than they are in the offline environment. This is borne out by our analysis of the top 30 titles in the respective rental markets. For offline rental, the top 30 titles accounted for 20 per cent of all transactions, whereas the top 30 generated just 10 per cent of total transactions in the online space.

DVD retail

518. In 1997, the year before DVD was launched, 5,349 titles were released into the video market. By 2005 the annual release slate had increased by 62 per cent to 8,679 titles with the DVD format acting as a catalyst for growth. The increase is not due to a rise in the number of new releases from the major Studios, it is instead an indication of the explosion in catalogue product, independent titles and niche product.

519. The broader range of titles available in the market has seen sales spread:

- in 2001 the top 30 titles accounted for 25 per cent of sales
- in 2006, the top 30 titles accounted for 13 per cent of sales.

Figure 171: Consumer research - Distribution of Internet users according to frequency of DVD rental

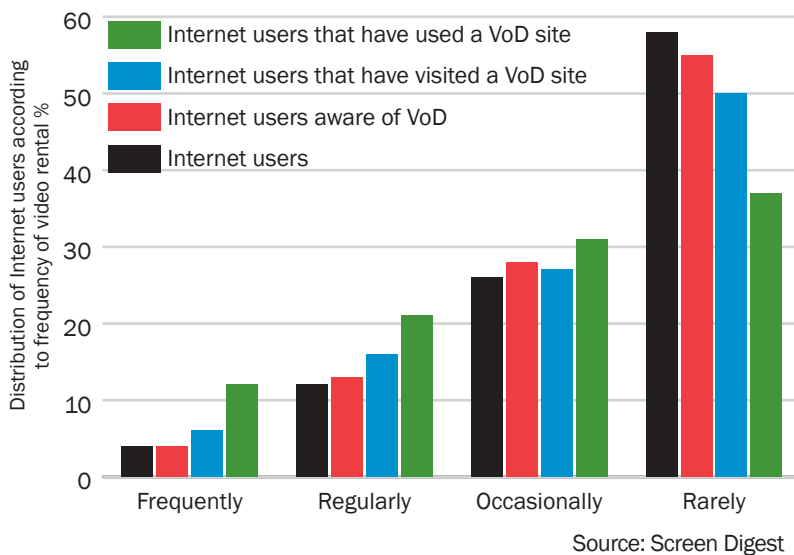


Figure 170: Consumer research - Distribution of Internet users according to frequency of DVD rental

		frequently	regularly	occasionally	rarely
Internet users	%	4	12	26	58
Internet users aware of VoD	%	4	13	28	55
Internet users that have visited a VoD site	%	6	16	27	50
Internet users that have used a VoD site	%	12	21	31	37

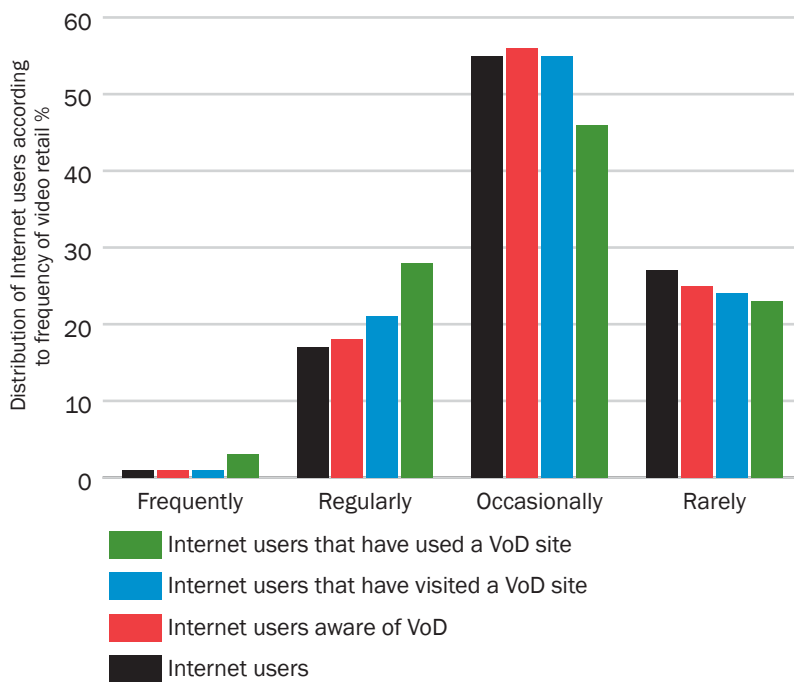
Source: CNC/Novatris

Figure 169: Consumer research - Distribution of Internet users according to frequency of DVD retail

		frequently	regularly	occasionally	rarely
Internet users	%	1	17	55	27
Internet users aware of VoD	%	1	18	56	25
Internet users that have visited a VoD site	%	1	21	55	24
Internet users that have used a VoD site	%	3	28	46	23

Source: CNC/Novatris

Figure 172: Consumer research - Distribution of Internet users according to frequency of DVD retail



Source: Screen Digest

520. This is evidence of the long tail, the concept that a wider array of titles, catering for niche markets, will attract a broader consumer base.

521. Online retailers are of course better positioned than their offline counterparts to exploit the long tail thanks to their 'elastic walls'. The architecture of the online environment is another advantage afforded to e-tailers, at it allows them to monitor user patterns which they can then exploit to direct consumers to other titles they may be interested in.

Pay TV

522. BSkyB's output deals include first release and library feature film titles. However, it is clear that packages are driven by titles which have been successful at the box office and are capable of generating strong audiences.

523. On the face of it, subscription services bear little relation to the 'long tail'

Figure 173: The 'long tail' effect across movie windows - Summary

	traditional	digital
Cinema (digital cinema)	Dominated by first run releases. In 2006, new releases accounted for 90 per cent of titles distributed, and 99 per cent of box office revenues.	By cutting print costs, digital projection will make re-releases much more cost-effective and (slightly) increase their market share
Retail (digital retail – DTO)	With low-cost DVD, library output is much wider: 8,400 titles in 2006 in the UK (+60 per cent in last five years). Top 30 sales account for 13 per cent of total (down from 25 per cent five years ago)	DTO will extend the online DVD trend to create a very diverse market.
Rental	Top 30 titles account for 20 per cent of high street rental.	Online rental (LoveFilm) offers 40,000 titles compared to 500 in high street rental. Top 30 account for 10 per cent only.
VOD	With true VOD and online VOD, library movie market share is estimated to grow from 5 per cent today to 25 per cent in 2011.	
Premium channels	Low share for library/niche content: Premium is about first-run movies. The 100 most-viewed films (of the 2000 shown per year on Sky Movies) accounted for 96 per cent total audience.	
Free-to-view television	Low representation of library content (about 10% of output and only for 'classic' films)	Digital channels create many more opportunities for library films in every genre/niche

Source: Screen Digest

Figure 174: Proportion of new releases in theatrical market 2006

	titles	share titles %	revenue £	revenue %	revenue/title £
New releases	505	90.7	834,250,639	98.7	1,651,981
Re-releases	52	9.3	10,848,797	1.3	208,631
Total market	557	100.0	845,099,436	100.0	1,517,234

Source: Screen Digest from Nielsen EDI data

phenomenon observed in online DVD retail and rental services. Customers pay a flat monthly fee to receive a service which does not depend on their actual consumption. In addition, a key advantage of output deals from the supplier's point of view is to enable it to sell weak titles by bundling them with stronger ones.

524. In a presentation of its 2003 interim results, BSkyB said that the 100 most-viewed films (of the 2000 shown per year) accounted for 96 per cent of its audiences. This concentration on hit titles is similar to that of cinema.

VOD

525. Historically nVOD has given over very little space to niche content or library titles. Of the £35m generated in 2001 in the UK only £1m came from anything else other than recent blockbusters. The nature of the platform means that the long tail is not a viable business model.

525-1. With true VOD however, which is now available to an increasing number of UK homes through cable and IPTV, more library titles can be offered (500 at any time on Virgin Media, 1,000 by Tiscali). Indeed, we believe the VOD market for library titles reached £5m in 2006. We expect it to grow to £23m to represent 15 per cent of the total VOD market.

526. In theory, Internet VOD permits services to offer an infinite range of titles and the share of niche titles and catalogue movies can be expected to be correspondingly broad. Of the 4m Internet VOD transactions that we expect in 2011, it is possible that 25 per cent will be library content.

9.7 Movie deals on television

Premium window

527. There are three types of deals between television operators and content providers:

premium pay TV, basic pay TV and free-to-air TV.

Premium pay TV

527-1. By early 2007, BSkyB had exclusive ongoing pay TV agreements ('output deals') with all of the major Hollywood Studios: Disney, Twentieth Century-Fox, Sony Pictures, Paramount, Universal and Warner Brothers. According to BSkyB, three of those deals (Disney, Sony and Fox) had been renewed 'recently'. BSkyB's agreement with Disney, for instance, was renewed in February 2006.

Window

528. The premium pay TV window follows 9-12 months after the home entertainment window (i.e. 12-15 months after theatrical release) and typically lasts 12 months. Output deals typically include all the theatrical releases of a given studio (not only the biggest blockbusters) up to a pre-determined limit (20, 35, 40 titles etc, based on historic track record) during the period. They will only rarely and by exception include films that were not or may not be released in the cinemas.

Duration of deals

529. Exclusive agreements between pay TV operators and film studios are called 'output deals' and run for several years. We understand that nowadays ongoing pay TV contracts typically last between three and five years.

530. Some years ago, the European Commission EC made clear its position that film supply contracts should be limited to three years. In the past, film contracts have been agreed for typically five years or even, in some cases, 10 years.

Number of showings

531. Pay TV operators typically acquire the right to show a film 24 times over the 12-month premium period over their various cinema channels. A 'transmission' is nowadays

Figure 175: Recent blockbusters v. library content in TV-VOD

£m	2001	2005	2006	2011
Blockbuster	34	55	78	145
Library title	0	1	5	23

Source: Screen Digest

described as a ‘transmission day’, which allows two screenings in a 24-hour period.

‘Most favoured nation’

532. The EC competition directorate opened an investigation into the contracts between Hollywood Studios and pay TV companies in 2002. One of the points at issue was the so-called ‘most favoured nation’ (MFN) clauses in Studio contracts which provided that favourable terms negotiated by any one US Studio in its contract with a pay TV platform would be offered to all beneficiaries of MFN clauses. MFN clauses, however, typically did not include unit pricing and volume.

533. The EC was concerned about ‘alignment’ of terms by the Studios that could be considered a cartel behaviour, and said that it found a ‘proliferation’ of the MFN clauses in the contracts that it investigated. Without admitting a violation of competition law, six of the studios decided to waive the MFN clauses in their existing agreements. The EC then closed the investigation and stated that insofar as they do not deviate from this new behaviour, further action was not envisaged against them. However the investigation remained open in respect of NBC Universal and Paramount Pictures, which have not followed suit.

Pricing scheme

534. Output deals work in several phases. At the beginning of the deal period the pay TV operator and the Studio agree on a framework rate card. For many years, this framework included a minimum guarantee (MG) irrespective of subscriber numbers, with ‘kickers’ when target subscriber numbers were achieved. Blockbusters (eg, those titles earning in excess of \$100m at the US box office) would typically earn a 100 per cent mark-up. Some smaller suppliers agreed a variable pricing grid, which reflected actual Box Office performance of each movie when released in the US and the UK (which is generally not known when the output deal is signed).

535. When (re)negotiating an output deal, a number of ex ante factors determine the grid of payment to US Studios. Some are related to the films themselves like the a priori potential of the film slate, over which the pay TV operator has little influence or even knowledge - it is rare for pay TV operators to know even

the planned titles in the later output years, let alone their potential value.

535-1. Another factor is the number of premium movie subscribers, which is by contrast central to pay TV operator business practice and under its control. Some studios do negotiate per-subscriber fees. However, others are reluctant to index their future payment too closely to the general performance of the pay TV platform or more specifically the number of premium movie subscribers, probably because the latter depends upon the pay TV operators’ marketing policy and shifting priorities between movies, sport, basic tier and new services such as broadband.

536. The actual audience rating of a given movie when it is broadcast in the premium window is never a variable in the price paid to studios.

537. We estimate that Hollywood Major Studios’ new titles account for about 50 per cent of BSkyB’s Movie channels film broadcast volume (transmissions). Library titles and independent titles make up about 50 per cent too, in a fairly stable balance. In terms of budget, the non-output movies probably account for only 10-15 per cent of total movie costs and the Hollywood output titles for 85-90 per cent.

538. Non-output films are acquired from independent distributors, often on a title-by-title basis. In that case, the value of one film is typically based on 10-15 per cent of the UK box office. Some independents can have output deals which reflect the terms of the Major Studio deals, but heavily discounted, as they clearly lack the same strategic value.

Basic pay TV

539. Basic pay channels (eg Living TV in the UK) secure movie titles from a range of distributors, but primarily from the Majors. Their access is typically subsequent to the first free-to-air window, and sometimes even the second premium pay windows (library), but some suppliers arrange parallel access to titles for free-to-air and basic pay channels. Licence fees paid by basic pay channels are typically at the same level as re-licence by free-to-air.

Free-to-air window

540. Free-to-air broadcasters in the UK have historically been reluctant to enter into output agreements with Hollywood Studios, in particular, agreements which bundle together rights to feature films and TV series.

541. However, the launch of Channel Five in 1997 (with a movie scheduled at 9pm every night), and the development of cable and satellite, have made long-term feature film supply agreements between studios and UK broadcasters more common. Broadcasters still tend to be eclectic, preferring to build packages around specific films, and adding tried and trusted library titles where possible.

Duration of contract

542. Unlike pay TV, licence periods are not limited to three years. Many run for longer periods of five to six years. The BBC has a rolling output deal with Dreamworks SKG under which it has acquired free-to-air rights for all of its live action films. The term of deals is often determined by the year films are released in the cinema: in other words, the contract will cover all films released in a given year, rather than having a start and end date.

Windows and showings

543. In principle, the free-TV window starts 24 to 27 months after cinema release (i.e. 12 to 15 months after pay TV window).

544. The number of transmissions varies from contract to contract, but is believed generally to be between three and five in a five-year

contract. One broadcaster said it aims to get four runs over a five or six-year licence period.

545. Independent distributors may license their films much earlier to free television as a broadcast transmission is likely to have a beneficial effect on DVD sales and rentals due to word of mouth. This could be as soon as 10-11 months after cinema release.

Pricing

546. Pricing is typically based on the UK box office achieved by a particular title. According to distributors, the typical formula is a fee-per-film of 20 per cent of UK box office. Broadcasters pay a premium for studio product compared to independents.

547. In the case of films which are licensed to free TV before their cinema release, the BBC (and possibly other broadcasters) pay an agreed licence fee but may pay more (or less) depending on actual box office. Pricing of library films which have already aired on TV may be linked to their rating performance when broadcast.

548. To summarise, the typical free-to-air rights deal for a given title include:

- Exclusivity on free-to-air TV starting 24-27 months after release and lasting 3 to 5 years
- Multiple showings, each showing being priced at a discounted rate.

Figure 176: General terms of television movie deals - Summary

	Premium TV	Free-to-air or basic TV
Format of deals	Output deals	Output deals are less typical, package arrangement or title-by-title deals more common
Variables influencing overall pricing	Some studios negotiate per subscriber fees; most are reluctant to index their revenue on the performance of the platform and require minimum guarantees	Largely inelastic to the reach or audience share of the channel, therefore blockbusters will remain largely out of reach of secondary digital channels
Variables influencing individual movie valuation/pricing	US and/or UK box office (mostly the former). The actual rating when the movie is broadcast is NOT a variable	Generally US and/or UK box office (mostly the latter). Minimum guarantee generally expressed as a ratio of UK BO (15 to 20 per cent). Those ratios depend upon the category of the channel (family-oriented have higher ratios because they attract key TV demos). The actual audience rating when the movie is broadcast is NOT a variable

Source: Screen Digest

Appendix

Methodology

General sources and credits

548-1. Screen Digest systematically collects industry reports from television and film companies on a regular basis, to inform its models. Screen Digest also meets industry executives on a regular basis for in-depth interviews, used to ‘fill-the-gap’ of official reporting and get feedback on our assumptions and forecasts. A number of industry contacts were interviewed specifically for the purpose of this report, about movie deals for example.

548-2. All the tables and forecasts in this report are therefore a combination of official data, in-house modelling, unofficial information and in-house assumptions, that are impossible to detail or trace systematically. To this end, Screen Digest is sourced at the bottom of most charts in this report.

548-3. In those instances where we have used third party data which is in the public domain (UKFC, CNC, Novatris, MPA, BVA, TNS, CAVIAR, BARB, etc.) the source is noted.

Cinema

549. Market level data (admissions, screens, box office) is from various industry sources including Carlton Screen Advertising, NielsenEDI and the UK Film Council (UKFC).

550. At the distributor level, our data is based on actual distributor market shares of the UK box office from Nielsen EDI. In terms of net income per distributor, we have applied a model based on total prints and advertising costs, and the estimated number of total prints in circulation, from the UK Film Distributors Association. We have devised that the US majors receive bulk discounts on the physical costs of the film and trailer prints, but that their advertising costs would be significantly higher. The model is based on the number of prints produced per film title, using the widest point of release as an indicator.

551. At exhibitor level we have applied actual exhibitor market share data from Nielsen EDI to Screen Digest’s informed knowledge of the levels of UK film rental agreements between exhibitors and distributors. All forecasts are based on Screen Digest’s interpretation of market trends, including industry feedback.

DVD

552. The retail and rental models are built on official market data from the British Video Association (BVA). On the retail side we used genre shares from the Official Charts Company (OCC) to extract sales for movies only. We then applied DVD retailer shares from Taylor Nelson Sofres (TNS) to determine the principal providers’ respective revenues. For those retailers supplied by wholesalers we estimated the cost per unit based on feedback from industry sources in order to account for the middle man’s share of

revenues. The gross distributor revenues are divided up amongst the studios using company market shares from TNS. In order to refine these values we built in the major Studios' new release: catalogue splits from TNS data. Using the resulting figures we estimated the distribution costs per new release unit and per catalogue unit based on feedback from industry sources to determine net studio revenues. The DVD retail methodology was the same across the offline and online sectors.

553. For rental, we assumed that all offline business was movies and, based on feedback we have received from the principal providers, estimated that 75 per cent of online transactions were film titles. For offline rental we used TNS rentailer shares, coupled with our knowledge of the terms of the principal providers' rental agreements with distributors, to estimate what proportion of the business was based on revenue sharing. We used the same methodology to calculate shipments of premium-priced rental units, both direct to rentailers, and via wholesalers.

553-1. This allowed us to determine studio revenues from offline rental. In the case of online rental, we used feedback from the principal providers to estimate what proportion of shipments were new releases and what proportion were catalogue. We split revenues amongst the principal providers and the rest of the market by applying market shares from TNS and our own estimates based on market feedback. After deducting postal costs we were able to determine net rentailer revenues. We then took gross studio revenue and combined it with the equivalent figure for offline rental to give total gross studio rental revenues. Applying the same distribution costs as we did for retail discs, we were able to extract net studio rental revenues.

554. For historical figures, we have applied the variables (e.g. principal providers' market shares, studio market shares) for the respective year where this data was available. Where it was not available we have estimated this based on data from another year. For forecasts, we have applied the variables from 2006 to our own total market projections.

TV VOD

555. The historic numbers and forecasts derive from a model that Screen Digest has long been using. It relies on the monitoring of every

UK VOD operator, in a bottom-up process (market totals are derived from company-per-company forecasts). The modelling is based on estimating/updating a large number of parameters: addressable market (enabled homes), average buy-rates by operator and by genre, pricing, etc.

556. The estimation of revenue shares in the value chain is based on general knowledge and frequent meetings with key players in the value chain (Virgin, ODG, etc).

Internet VOD

557. Unlike cinema or DVD, there are no official market statistics for Internet VOD. Our digital retail and digital rental models are instead based on information that we have gathered from a relatively immature market.

558. On the retail side we have calculated market revenues based on sales reported by principal providers and an average download price. We estimated the cost per unit for the distributor based on feedback from industry sources and applied this to the total number of transactions. We determined principal provider revenues by estimating market shares, deducting portal costs where appropriate. We calculated major distributor revenues on the basis that they accounted for an estimated 65 per cent of transactions and their wholesale prices are around 65 per cent of the download fee. For independents' revenues we estimated that they represented 35 per cent of transactions and charge a wholesale price that is around 55 per cent of retail price.

559. On the rental side we have calculated market revenues based on transactions reported by principal providers and an average rental fee. Using the same assumptions for delivery cost per unit as the retail model and deducting portal costs where appropriate, we determined rentailer revenues net of costs.

559-1. Principal providers' shares of this figure are estimated based on several factors (reported transactions, the number of titles and the number of studio deals). Our model assumes that digital rental deals are based on revenue sharing agreements. We have calculated gross distributor revenues on the basis that majors accounted for 65 per cent of the market and independents 35 per cent, with major distributors securing slightly higher

share of revenues (55 per cent) than their independent counterparts (30 per cent).

560. For forecasts, we have applied 2006 proportions to our own total market projections.

Television

561. Typical general terms for pay and free TV movie deals have been assessed from general industry knowledge and contacts with insiders involved in deal negotiations on both sides (studios, broadcasters). In pay TV, the number of premium movie subscribers is derived from (patchy) BSkyB reporting of their movie/sports premium subscribers at fiscal year end.

561-1. The premium revenue specifically attributed to movie channels is arbitrary because: (i) the pricing of the movie option depends on the combination chosen by each subscriber, (ii) the value of having movie channels has an indirect impact on subscriber acquisition that goes beyond the mere monthly revenue attributed to this specific 'mix'. In this model, we estimated 'movie revenues' through to the proportion of movie subscribers of all premium subscribers, according to the following formula:

$$MR = PR * MS / (MS + SS)$$

with

MR= Premium movie Revenues

PR= total Premium Revenues

MS= Movie Subscribers

SS= Sports Subscribers



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