

*THE BUSINESS OF MEDIA DISTRIBUTION, SECOND EDITION:
MONETIZING FILM, TV, AND VIDEO CONTENT IN AN ONLINE WORLD*
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ONLINE SUPPLEMENTARY MATERIAL

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CHAPTER 1: Market Opportunity and Segmentation — The Diverse Role of Studios and Networks

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

Range of Relationships

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

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

Puts

Under a put arrangement, a producer or director may have the ability to force the studio to

finance and distribute a project, as long as certain defined specifications have been met. These deals are rare: no one wants the obligation to blindly make a film, no matter who is involved.

Puts are, accordingly, usually limited to joint equity arrangements in which a filmmaker with a preset deal can invest in a project and force the studio to co-invest and release the property. Even in this scenario there will be very specific hurdles to trigger release including budget parameters, on-time delivery, ratings, approvals over attached elements, etc. Under the deal the parties will have pre-agreed key economic terms, such as: (1) the studio's commitment to pay for defined tiers of prints and advertising/media to release the film, (2) distribution fees, (3) recoupment of production and release costs, (4) ownership, and (5) relative splits of profits from defined revenue streams.

First Look Deals

Much more common than puts are first look deals. Under a first look deal, the same litany of economic terms are agreed up front, so that the only issue the parties face is literally whether to make the film, rather than what are the terms between them if the film is made.

In many regards, a first look deal is the goal of every producer and director. What they gain is financing to develop story ideas with studios covering a fixed portion of their overhead, including in cases funding to hire writers. In essence, a first look deal pays the rent and allows directors, producers, and writer-producers the freedom to create. As they say: It's a good job if you can get it.

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

following items are often required:

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

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

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

- More drafts of the script to get to a shooting script
- Signing key talent including actors, a director, and line producer
- New or additional visual development

- Delivery of budgets
- Commitment of financing if there are other parties involved

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

In the end, when the studio accepts the project it controls its destiny and takes it off the market — all things it wants, but all things for which it will pay dearly. For the producer (and I will continue to use the term producer liberally here, for it could be a director or writer), it means he/she is one step closer to the goal of filming the project and transforming an idea into a movie or TV show; additionally, it means more funding can be secured.

All of this supposes that the studio likes the submission: But what happens if they are on the fence? Despite the studio sitting in the enviable seat as a buyer with lots of properties from which to choose, the decision is a difficult one and different from many other supply chain situations where purchasers tender a request-for-proposal and review the pros and cons of suppliers' bids. There are similarities in that issues of reliability, quality, relationship, and cost will all be taken into account. However, because of the first look relationship on which the decision is premised, many of these issues are already set and the decision comes down to two fundamental questions: how much do I subjectively like the project, and what are the chances that

if I pass on it my competitor will produce it and make me look like a fool?

The second question is made more difficult because you are likely dealing with someone either famous, or if not outright famous than likely highly regarded and well connected; if that were not the case, there would be no first look relationship to begin with. The threat of taking a project across the street to a bitter rival and having the ability to actually produce it with them is very real. Hollywood is littered with the lore of so-and-so passed on that project or he had the courage/vision to get behind X. Careers are literally made and broken on these decisions. Despite all of these complications and tough decisions, first look deals are still a staple of Hollywood because studios want to make movies and they want first access to the people they want to make them with. Paying for what amounts to a type of option on an exclusive has therefore evolved as a hedged economic alternative. As the business has matured, and individuals have gained more clout, it could now be prohibitively expensive to keep individuals on the payroll. Gone are the Studio System days when stars literally worked for the studios and were contracted to make a certain number of pictures.

Accordingly, first look deals have evolved as a middle ground. For a price studios secure access to ideas and talent, but gain flexibility by not actually committing to make any picture or a specific number of pictures with an individual. Producers/talent have someone else pay for what they want to do anyway (without a first look deal they would still be developing properties, but on their own nickel), and maintain the freedom that if the studio is not keen on the project they can take it across the street to a competitor because the first look deal creates no barrier to getting the project made. From an economic standpoint, a first look deal is the ultimate hedging of bets on both sides.

CHAPTER 2: Intellectual Property Assets Enabling Distribution — The Business of Creating, Marketing, and Protecting an Idea

THE DEVELOPMENT PROCESS — DEVELOPMENT GUIDELINES

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

Is the Idea Sustainable, or Big Enough?

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

Is the Idea Original?

Several questions are invoked by the term original. First, is the idea stolen or too close to another idea to be a violation of a third party's copyright? Second, will others view it as original, or will it suffer by an easy comparison (oh, that's just like X, but with Y). Third, is there a competitor making or developing something similar? Oddly, Hollywood tends to be a

business where the answer to this last question may not matter. There are numerous cases of studios rushing projects forward to beat a competitor to market on a similar theme. Disney/ Pixar made *A Bugs Life* at the same time DreamWorks/PDI was making *Antz*. Similarly, in 2000 Disney and Warner Bros. both released movies about missions to Mars (*Mission to Mars* in March and *Red Planet* in November, respectively, starring Gary Sinise and Val Kilmer). In 1998 DreamWorks and Disney each released films about a meteor hitting earth and threatening the end of the world (*Deep Impact* in May and *Armageddon* in July, respectively, starring Tea Leoni/Robert Duvall/Morgan Freeman and Bruce Willis/Ben Affleck). Having started this paragraph asking is the idea original, I will end it by asking, does it matter?

Is the Idea Inherently Expensive or Modest to Produce?

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

Does the Story Lend Itself to the Medium Contemplated?

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

Does the Concept Have Franchise or Merchandising Potential?

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

A Will Farrell or Steve Carrell movie is a completely different product than a kids' property hoping to tie in a toy line.

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

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

* * * * *

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

Market Timing

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

Is There a Well-known Source upon which the Movie is Based?

As previously discussed, producers are always looking for ideas with built-in awareness such as books or mass market news events. A perfect example would be *The Da Vinci Code*, a high-profile movie from Imagine, directed by Ron Howard and starring Tom Hanks, based on

Dan Brown's novel, which was a phenomenon lingering atop the *New York Times* bestseller list for years. With the book still immensely popular, the movie launched the 2006 summer holiday season in May (opening May 19, 2006, the weekend before Memorial Day weekend, which has become among the most if not the most coveted release date of the year).

Is There a Hot Genre?

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

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

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

In 2000 there were no pure reality shows in primetime on the four big networks, but from 2003–2005 the genre exploded. Examples of reality shows during this period included *Survivor*, *The Bachelor*, *The Bachelorette*, *Meet the Parents*, *The Simple Life*, *Nanny 911*, *The Apprentice*, *Home Makeover*, *Big Brother*, and *Queer Eye for the Straight Guy*. The trend spun off into talent competitions such as *Dancing With the Stars*; the talent competition champion *American Idol* even catapulted to the top of the Fox network despite the underlying concept being close to the old *Star Search*. (It is unclear whether the phenomenon is driven by the interactive ability of viewers to participate via text messaging or whether the audience prefers caustic judges who may embarrass contestants rather than avuncular hosts; compare the blunt and charismatic Simon

Cowell sparring with his co-judges to Ed McMahon, the former sidekick to *Tonight Show* host Johnny Carson). The success of the show led to similarly formatted celebrity judged shows such as *America's Top Model*, *On the Lot*, *America's Got Talent* and *The Voice* among others. [Note: Many attribute the growth of reality shows to a time when networks needed to fill the airtime with non-scripted fare during a prolonged writer's strike. When the results proved comparable in ratings and less expensive to produce, there was no turning back (see also discussion in Chapter 6 of NBC's elimination, though short lived, of its third hour of primetime in favor of a Jay Leno hosted talk show moving from his *Tonight Show* slot).

Is There a Hot Demographic?

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

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

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

OPTIONING PROPERTIES — THE OPTION CONTRACT

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

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

Once all the nuances are negotiated, and legal definitions, representations and warranties, approval rights, credits, etc., are added, this simple skeleton will balloon into a lengthy document. Options are more complicated than they may seem at first, for while the agreement may strike a middle ground by deferring the lion's share of the money until a later date (e.g., the purchase price), the agreement needs to predefine what happens if the option is exercised. This

means that the agreement will usually define services (if the creator is to play any role in development or production) and detailed compensation triggers expressed in bonuses or shares of profits.

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

COMPENSATING WRITERS — INDEXING VALUE TO DEVELOPMENT VERSUS DISTRIBUTION RESULTS

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

Writers as the Catalyst for any Project — the Unsung Heroes

Every good producer and director will advise that a successful property is all about the story (which underlies why optioning properties is so competitive). If the story and script are

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

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

Everyone is trying to get it right, but according to multiple Academy Award winning screenwriter William Goldman's (credits include *Butch Cassidy and the Sundance Kid*, *All the President's Men*, *Marathon Man*) –“nobody knows anything” mantra: Not one person in the entire motion picture field *knows* for a certainty what's going to work. Every time out it's a guess — and if you're lucky, an educated one.¹

Such cynicism fails to halt the rush of scripts created daily, but it does underscore the often misunderstood value of scripts. In Hollywood and to executive producers, writers are valued

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

Economics of Hiring Writers

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

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

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

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

A final element influencing the economics of structuring writer's deals is the Writer's Guild of America (WGA). Unless someone is already an established and star writer, the leverage rests with the party paying the salary, which historically was the studio. The WGA is a union that has entered into a collective bargaining agreement with most key clients; namely the studios, networks, and key independent producers. It is through the leverage of this agreement that writers are able to secure residuals, minimum tiered compensation for writing services, and an independent rules-based system for determining whether they are entitled to credit based on their work. The guild agreement provides key protections to writers, ensuring attribution

(including guarantees regarding where and how credits are placed) and compensation thresholds that they would likely not be able to achieve without this framework.

Guaranteed Compensation

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

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

Bonus Compensation

Writers typically receive two types of bonuses: a cash bonus and a percentage of the net profits. Both types of bonuses are contingent on the picture getting made, and the amount of the bonus is contingent upon the type of credit the writer receives. The WGA will determine final screenplay credit and accord either sole or shared credit. Bonuses are then indexed to credit accorded with sole credit vesting 100% and shared credit a lesser sum, usually 50%. (Note, it is uncommon yet theoretically possible for more than two writers—with a team of writers being considered a single writer—to receive shared credit, making the calculation of potential bonus

compensation complex and uncertain for the financing party.) With respect to the fixed sum or cash bonus, the bonus reflects that the writer's work was good enough to get the picture made — an objective standard and a pivotal milestone. Accordingly, bonuses are carrots and can be quite large, even in cases reaching 100% of the initial fixed compensation.

Contingent Compensation

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

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

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

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

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

The One Liner

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

Story and Selling Keys

There are books and experts on story and creative writing, and it is not the intention here to give a tutorial on how to become a writer or craft the perfect story. That said, the marketing of a film idea follows certain patterns, and without an understanding of the rhythm and market

nuances marketing attempts are an uphill battle (possibly making what is already an uphill battle a doomed endeavor). Securing a meeting with someone willing to take a pitch is a very difficult task; securing a meeting with the right person and someone who has authority to make a yes/no decision (i.e., the gatekeeper) is even harder. When set to pitch a project it is a business essential to be prepared, polished, and ready to address a range of likely questions.

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

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

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

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

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

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

Example 1 — The creative executive likes to -make the discovery, and may even want to claim credit. This is the needle in the haystack scenario: the creative executive likes to meet with the source, and if instead a company sends a smooth pitchman the idea may not stand a chance. The key to succeeding with this type of executive is to send the creator: the buyer wants to meet and discover the raw, creative talent. If the company does not believe the individual to be a good pitch person or spokesman, then there is always the option of sending along a chapter one.

Example 2 — Send your best salesman. The best creative people are not necessarily the best fronts for selling. If a key creative is an exuberant and charismatic pitchman then the company is lucky. Approach this type of sales from a common sense basis: Who on my staff can tell the best story, make me laugh, get me interested, and hold court to draw in a decision maker on the other side?

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

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

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

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

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

MARKETING IDEAS (AKA PITCHING) — WHAT MATERIALS DO YOU NEED FOR A PITCH?

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

Too Little

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

Too Much

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

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

materials must be weighty enough to convey and spark the story, but short enough so there is time to pitch multiple ideas.

Too Costly

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

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

Mini-Bibles

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

1. Film

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

2. Television

- Proposed title
- One sheet that gives a high concept verbal and visual description
- One sheet or short concept treatment of series premise
- Main character descriptions/profiles accompanied by visuals, showing range of views/emotion of character
- Ancillary character profiles and visuals
- The show formula/how the series works (e.g., X will always solve a mystery)
- The setting

- The educational value (if appropriate) or moral message
- Episode premises

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

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

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

PROTECTING CONTENT: COPYRIGHT, PIRACY, AND RELATED ISSUES — TRADEMARKS AND PATENTS

In the case of a movie, the studio or producer (whoever owns the merchandising rights) protects the specific product by registering its trademark (e.g., Batman logo) for use in association with a particular good or product (e.g., a toy). An important legal tenet of trademark law is that the product for which trademark protection is being sought is actually used (or will be

used). Because trademarks exist to distinguish one brand from another, they cannot be defined in theory but rather must have actual real-world uses.

Trademark Registration; Costs of Maintenance and Administration

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

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

Trademarks:

Buzz Lightyear

Woody

Toy Story

Categories:

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

Territories:

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

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

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

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

intellectual property, the facts of each case are often determinative, and the ambit of how close is too close provides fodder for trademark counsel and legal scholars.

Patents

Like copyright, patent rights find their origins in the US Constitution, which grants authors and inventors the exclusive right to their respective writings and discoveries in order to promote the progress of science and art.² The difference between exclusive in this context versus copyright is that patents afford their owners a monopoly on the invention for a set period of time. The US Patent and Trademark Office (USPTO) summarizes a patent as Sanctioned monopolies on the subject matter recited in the claims of the patent. A country's laws accordingly grant a patentee a right within its territory to bar others for a set period of time (e.g., 20 years) from using, making or selling the subject matter disclosed in detail in the patent. When the set period of time runs out, the subject matter of the patent enters the public domain and can be used freely by anyone in the territory.³

Similar to trademarks, the USPTO's Web site is a simple and easy way to gain basic information.⁴ The fundamental tenet for obtaining a patent is that the invention must be novel and non-obvious. While we tend to think about patents today in high tech terms, some of the best examples of patents historically are more associated with innovation than pure technology, for example, the paper clip and zipper.

Software Patents and its Increased Importance in Digital Processes

In terms of entertainment, patents have always been important in production (think of camera technology) and are increasingly valuable in today's digital world. Patents can be applicable in production (such as digital production utilizing computers and 3-D graphics), distribution (such as manufacturing processes for DVDs or Blu-ray discs , or security mechanisms to thwart piracy and authenticate consumers' access to content, are examples of a patented technology), and exhibition (such as Digital Cinema and Imax, both of which rely on patents).

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

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

1. The patent could be a source of revenue. If the patent is in demand by others, a licensing program can be established.
2. The patent could provide for a competitive advantage; there may be reasons to secure the rights, but not to license the technology to others; as noted previously, patents are essentially a legal monopoly for a limited period.
3. If a company does not pursue a patent, a third party could develop something similar. This leads to the fear of having to pay license royalties, or in the extreme case, potentially being put out of business.
4. There may be reasons to develop a portfolio of patents which, as assets, can cumulatively become even more valuable or are available to license in a trading context (cross-licensing) when seeking a license from a third party.

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

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

CHAPTER 7: Internet Distribution, Downloads, and On-demand Streaming— A New Paradigm

CATEGORIES OF MOBILE PHONE VIDEO CONTENT

NOTE: The contents of this Section [Categories of Mobile Phone Video Content] regarding mobile phones has not been updated since the 1st Edition (2009). Much of what is discussed in the next several pages seems anachronistic, almost from a history book, and yet the text is but a few years old. I have left this material in to illustrate the pace of change from the now standard multi-screen world. Whereas phones were originally viewed as a new platform and even window, in which content was bundled, optimized and even created just for mobile, the new age of ubiquitous smart phones and apps has made the phone in many ways simply another screen. There are still unique facets, such as customized ringtones, and the ability to utilize the phone as a smart remote control; however, the notion of a phone driving new types of TV offerings has passed and as discussed in Chapter 7 phones are a new digital gateway pulling from the panoply of video offerings.

The following is a very general overview of mobile phones in the context of a third screen beyond the TV and computer monitor. Tackling the broader ecosystem and economics of the mobile phone space, even limited to video content applications, is beyond the scope of this book. Accordingly, the following summary is focused solely on highlighting efforts to customize video-based content to leverage the mobile access point, together with identifying certain related macro trends influencing the relatively new application of distributing content via cellular phones.

Customization; Repurposing Content; Made-for-Phone Originals; Pushed Content; Simulcasts

Maybe the best way to capture the growing market is to look at the following categories: content that merely customizes a phone, content repurposed from another medium for viewing via a cell phone, content created specifically for mobile phones, content pushed to cell phones to promote third-party products, and live television content accessed via a phone.

The first category, customization, includes features such as ringtones, which is more of a merchandising element than a video feature (see Chapter 8). This segment represents the first

content offerings in the market, the initial largest revenue stream, and correspondingly the most recognized feature.

The second major category is access to information or content aggregated or created for another medium and repurposed for use via cell phones. One of the best examples is sports programming, where mobile carriers like Sprint signed deals with groups such as NASCAR or the NFL to provide clips and data. This targeted customization and aggregation of content soon led content owners to believe they could leverage their brands and actually create a custom phone. A prime example was ESPN, which launched the ESPN phone during a Superbowl advertising campaign in February 2006 (Superbowl XL on sister network ABC). The new ESPN service Mobile ESPN was labeled a mobile virtual network operator (MVNO). It was virtual in the sense that it did not have the physical wireless network infrastructure, but rather leased it from Sprint and then marketed a consumer brand via its rental capacity. ESPN's pricing debuted with a variety of tiers, not unlike other mobile carriers, and beyond voice minutes and wireless Internet access provided subscribers access to video clips, ringtones, statistics, scores, and real-time sports news.⁵ Despite these features, and the potential for sending targeted subscriber alerts, the ESPN phone and other so-called MVNO phones have largely failed.

Perhaps a reason why themed phones have not been successful is that it is simpler, and ultimately cheaper, to package information, such as sports updates and news, among a bundle of icon links at the consumer's fingertips. A mobile carrier may aggregate content, which is then offered in themes/packages such that subscribers can scroll through choices (which still allows for co-branding opportunities). An example would be watching the top 10 list from David Letterman on your phone in the morning, or catching last night's *The Daily Show* introduction that you missed because it was on too late. The model is akin to the Internet in that the goal is to drive as much traffic as possible because economics are driven by viewing and access. When

this market was just emerging (around 2006), examples of initial network offerings included a CBS branded CBS To Go bundle (including clips from shows such as *Survivor*, *Late Show with David Letterman*, *CBS News*, and *Entertainment Tonight* (on Verizon's V CAST service) and a similar package of select NBC content (clips from *Access Hollywood*, *The Tonight Show with Jay Leno*, and *NBC News*).

Another category of repurposed content is games. A phone is fundamentally based on pressing buttons, so applying the platform to an interactive product is a natural fit. Early generation cell phones came bundled with very simple games (e.g., Tetris), while new smartphones with improved memory and graphics capabilities have significantly opened up the gaming options. Content is expanding so rapidly that many options tend to fall into the impulse category, and it is the expectation of the unknown (i.e., knowledge that new games and applications, even if not known about at the time of purchase) are possible that excites many consumers. When buying an iPhone, how many purchasers expected they would use the device to fritter away free time virtual bowling (versus knowing that at some level they would tap into innovative items)?

The third category driving offerings is original content. By original content I mean content produced specifically for and targeted at users in the cell phone market. On the Web, we started seeing shorts that were quickly labeled webisodes; not to be outdone, studios (led by Fox) coined the phrase mobisodes with respect to original content for mobile phones. Mobisodes are short pieces, such as a minute or two, that can be wholly original or ancillary to a branded long-form property.

20th Century Fox, for example, produced mobisodes of its hit TV series *24*. These short pieces tied into the plot of the TV series, and provided the viewer more background or insight into the show's world, much like a book or videogame linked to a major franchise can dig

deeper and bring new arcs and story around the main storyline. Fox started its initial season producing one-minute pieces, and separately branded the show *24: Conspiracy*. The show was available in the US market exclusively via Verizon wireless' V CAST service and was successful enough to warrant a renewal (where season two mobisodes were expanded to two minutes in length).

The trend seemed to catch on, and CBS followed suit developing a soap opera that would run original mobisodes daily, targeted initially at either 5 or 7 days/week and 3 to 5 minutes an episode. Whether this niche programming remains viable is an open question, and much like original made-for-the-Web content, producers are struggling with monetization absent sponsorships and embedded product placements. Again, a new model without accepted and proven advertising units is a difficult proposition, and it may be that original content for phones needs to integrate interactive elements (e.g., text messages, vote for X) to pay for production costs. Further, it is debatable whether webisodes and mobisodes really need to be separate markets. A more efficient approach might be to play across (and amortize/monetize across) multiple platforms.

The fourth major category is marketing and advertising. Content can be pushed or made available to cell phones, much like an advertisement can be tied to a site or message on the Internet. The issue here is more consumer tolerance rather than feasibility. To grow the market most providers want to enhance the consumer cell phone experience and are wary of pushing ads that could be deemed intrusive. A movie trailer is a perfect example of a short piece of information that can be accessed, and provides both helpful and (perhaps) entertaining information to the user while serving a marketing purpose for the provider. It is likely this form of more subtle advertising or promotion that users want to access (rather than something that is foisted upon

them like a pop-up ad) will fuel the space. It is probably worth noting that privacy is an inherent and critical assumption here. In a nightmare scenario, the phone service provider could license customer lists and your cell phone could ring with the same annoying telemarketer/programmed calls that have become such a nuisance at home; worse still, with graphics and avatars the product or message could be imposed on the receiver. This is hopefully a world we will not see, but one technology could allow if legislation or market forces (i.e., customer back-lash) do not impose restraints.

Finally, in the literal sense of a -third screen cellphones are being converted into portable television screens that can exhibit live TV. Companies, such as MobiTV, have entered into deals with major cell phone carriers to offer subscribers the option of adding on service. Much like a cable carrier, you can add a menu of options to your phone: instead of simply having Internet access, you may choose to subscribe to a number of channels or even a VOD service. Via the on-screen menu, a user can select a channel such as MSNBC or NBC and watch live (a mobile simulcast), converting the phone screen to a mini-TV. Whether it will be commonplace to watch a channel via your phone (or merely sample content such as viewing highlights), the cellphone is destined to become a ubiquitous portal to content previously only available via television receivers. This is already commonplace in several international markets where consumers expect to access broadcast networks while on-the-go.

The iPhone Revolution

The iPhone revolutionized mobile phones in a number of ways, but perhaps most important by (1) transcending the inherent audio nature of the phone to make it a truly audio-visual device, and (2) enabling third-party applications, further diversifying the device to become a portable, interactive monitor for just about any video application one can imagine. Smartphones had enabled a myriad of features, but until the iPhone the notion of truly playing Monkey Ball on

a phone or a range of other mini-games was difficult to imagine.

In the first month that Apple opened up the device for third-party applications, users had downloaded ~60 million applications which translated to \$30M for that month. (Note: Many iPhone applications are free.) Although it is too early to project the continued pace, Steve Jobs was bullish enough to muse, as reported by CNET: –Who knows? Maybe it will be a \$1 billion marketplace at some point in time?⁶ Roughly a year later, more than 40 million iPhones and iPod Touches had been sold, and application downloads from the Apple App Store surpassed 1B.⁷

Back to the mantra of what you want, whenever you want it, and how you want it, the iPhone embodies the iterative expansion of access points for media. Not everyone will want to play a game on their phone rather than a console, but the point is the option now exists – a tangible rather than conceptual link of game, TV, and Internet portability. The knock on TV interactivity has long been the remote control, and what the iPhone expresses is a user interface enabling a consumer to navigate the dizzying Rolodex of content choices and then instantly access and consume them. The long and short tail is now in the palm of your hand.

This access point instantly poses another window question as a new display medium (is the game on the iPod a new window, how should mobile simulcasts be treated, etc.). Complicating the categorization as well as windowing of content generally, the device is also a super-browser enabling consumers to pull in content from all available Internet accessible sources. The headache (or blessing, depending on your outlook) of Internet access for content owners is quickly being extended from the connected world to the wireless world.

Windows and Economics

Window

The window is evolving and will vary by type of content. Because the limited screen size

and battery life inhibits long-form programming, the most efficient current uses have been making the phone an access point to supplementary information such as mobisodes tied to a franchise, stats on teams, mini-games and breaking news. For all of these items there is a sense of immediacy, which dovetails into the inherent nature of a device that is, after all, designed for instant real-time communication. As such, it is no surprise that these types of applications dominate mobile telephone content. For longer browsing, research, and applications that take time, people are apt to default to their PC and the flexibility of broadband speed and better user interface (larger screen and better sound).

Regarding live TV, the window need not be simultaneous with TV — although that is preferable for the mobile providers and TV channels are frequently available via mobile simulcast in Europe — and conceptually should mirror Web streaming access. Consumers will demand simultaneous access for live events such as sports, but for TV broadcasts it is likely networks will want to protect the TV premiere and then add this as a platform akin to free VOD via set top box and Web streaming (which in turn, depending on the level of adoption, may cause broadcasters to want to aggregate this viewing within its live + X days rating absent efficient streaming monetization).

INTERNATIONAL ASPECTS OF MOBILE PHONES AND INTERNET DISTRIBUTION

Restricting Access — Language and Geofiltering

Given the challenges of controlling Internet traffic, the elimination of physical boundaries with roaming phones, and the resistance to censorship, the two principal methods of limiting digital access to content across territorial boundaries are differentiating language and geofiltering. Language is simple: a site in one language that does not have a localized/ translated site and URL will be inherently limited in its desirability, and access is limited by practical constraints, rather than technology. Geofiltering (which tends to be limited to the Web, as phones are tied to the subscriber and roaming access) makes it possible to code access and restrict entry to a site where the user comes from a location that is geographically tagged for limited or restricted access. Again, this can be defeated by routing entry through a local site. Depending on the sophistication of the geofiltering, the site may still recognize the source computer and defeat the hopscotch of links used for entry. In an extreme case, the out-of-market consumer could easily establish a US based Web site or e-mail address making the process more difficult. In essence, this is no different than preventing hackers or piracy. Those who want to defeat a geofilter will be able to skirt the security. However, the goal is not 100% exclusion, but rather erecting enough barriers to make the process challenging and time-consuming enough to minimize the impact.

With all of these barriers, one also has to focus on the counterintuitive goal of the process: The whole discussion is about keeping consumers away! Many argue it would be easier to let everyone in who was interested, and write off the fact that a percentage of traffic is international and that the local traffic may be a few percentage points overestimated. In a truly global business none

of this should matter, but at a consumer level and especially where sites are monetized, advertisers will want to be associated with local customers.

Currency as an Obstacle, and Parallels to Other Markets

Most people do not focus on the credit card based financial transaction when discussing geofiltering and access. Ultimate consumption, though, is currency based and most people want to (or need to) pay in their local currency. A consumer in London with a pounds sterling credit card is unlikely to want to buy something via Amazon US in dollars versus Amazon UK in pounds. To the extent that taxes or pricing differ, this can be equalized by surcharges creating disincentives to play the currency market for product. Further, to the extent a consumer can gain a cheaper price by shopping forums, there is again the element of practicality: How many people will do this, and is it worth creating barriers and solutions to solve less than 5% of the problems? Today this problem has been mitigated by sites that will convert currency and accept foreign credit cards or trusted online payment systems (e.g., PayPal); in fact, many sites now outsource payment processing to sophisticated third parties which sort this out in the backend, making currency less of a barrier for global consumption.

Of course, payment processing hurdles completely give way in the context of free access streaming as opposed to paid consumption. A consumer from anywhere in the world can log onto ABC.com or Hulu to watch a free streaming repeat with geofiltering providing the only obstacle. The network/service is likely to view this additive track as promotionally beneficial, and the economic consequence is whether ratings and value for international licenses of the pro-program will decline because a certain percentage of core consumers have already seen the program. This then becomes similar to the issue of parallel imports in video and day-and-date re-leases for films; these markets have addressed economic losses from early access to content by accelerating windows and creating simultaneous worldwide access. TV will

inevitably move the same way, and in many major/mature markets has already moved to day-and-date patterns given this pressure. This is a significant change in window patterns from the days—not long ago—when season one of a hit show ran in Europe when season two premiered in the United States.

The Explosion of Video on the Web

By the mid-2000's, everyone was predicting a revolution in the world of video content and how programming would be consumed over the Internet as opposed to traditional television viewing. At the World Economic Forum in Davos, Switzerland, Bill Gates proclaimed: "I'm stunned how people aren't seeing that with TV, in five years from now, people will laugh at what we've had."² *Wired* magazine, in an article that also asked how a couple of students "make their way through the 5 billion-channel online universe to you," spoke of the changed dynamic in nothing short of revolutionary terms:

Online video has arrived ... Thanks to growing bandwidth, easy access to the means of production, and cheap storage, it's exploding all around us and becoming a very real, very different way to experience news and entertainment ... What's happening here isn't just TV online. Gone are the rigid 30- and 60-minute blocks; now the clip is it — be it 30 seconds or eight minutes, we're watching only the money shots. Gone is top-down broadcasting; instead, the network has been, well, networked, with thousands of creators and places to watch ... And gone, too, is the at-this-time, at-this-channel programming; now, we're not only time-shifting with DVRs, we're space-shifting as well, watching stuff on our laptops, iPods, and cell phones — even loading it back onto our TVs ... What's on? Whatever you want.³

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

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

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

Change Could Have Been Even Faster:

Speed and Quality as Limitations to Adoption and Downloads

A limiting factor to download adoption has been the immaturity and historically slow speed of the delivery mechanism. Films and TV shows are dense graphic files, and the download speed is still relatively slow (especially when compared, for example, to the time to download a song or even full album). The total file for a film is in the range of 1 gigabyte of data, and yet even over a broadband connection the download time is closer to 1 megabyte/second. [Note: speed is also impacted by quality/density of data, with HD content taking significantly longer than SD content to download] At over 90 minutes of content, the total download time of a film can still exceed an hour, and for a long film can be closer to an hour and a half (e.g., a movie needs about 1 gigabyte of hard-drive space and can take less than an hour to download via a high speed Internet line⁹). The pure inconvenience of this lengthy download is a clear inhibiting factor, and the competitive advantage of peer-to-peer systems able to break content into scattered bits accelerating downloads is a key factor that stimulated

pirate services; however, despite comparatively slow downloads the market continues to grow. In theory, as download times decrease, and the population downloading content increases, this market should accelerate. However, while it was originally assumed electronic downloads would be the substitutional avenue for sell thru, today it is unclear what the balance will be given the growing adoption rate for subscription streaming and the evolution of cloud based digital lockers. A few years ago I would not have questioned the inevitable growth of downloads, but ubiquitous VOD and remote unlimited storage over time could obviate the desire for downloads and in fact eliminate the market (except for limited downloads to create resident copies for use when travelling or in other situations where Internet access is unreliable or unavailable). No longer are people postulating that downloads alone will cannibalize other windows and become the dominant method of acquiring content.

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

To DRM or Not to DRM

While DRM systems were responsible for giving studios comfort to release content in digital form, there are many that argue DRM is both contrary to the open nature of the Web and an inhibitor of adoption. Different hardware systems with different DRM technology create the potential for a whole new version of format wars. These are more complicated than the historical video market battles because there are multiple competing versions. The music industry struggled with DRM issues for years, and in January 2009 the record labels and Apple struck a new deal: the music industry abandoned its insistence on DRM and Apple agreed on flexible pricing (moving off the \$0.99/song structure and allowing labels to differentiate pricing and charge premiums for new and/or hit songs).⁷ Consumers were arguably ecstatic, as the knock on DRM had been the inability to move libraries from one system to another, thereby locking a consumer into its portable storage device and limiting flexibility in terms of download sites and devices (ironically, making portable media to a large degree non-portable).

The same dilemma faces the Hollywood studios over video content and, with DRM often perceived as synonymous with copyright protection, simply allowing free access is not a favored solution regardless of the music industry's stance. One suggestion has been an industry registry, a kind of clearing house where consumers can register their device. Movies and TV shows downloaded from different registered sites could then be matched and played on any device similarly registered by a manufacturer.⁸ If one believes in the historical trends, then it is likely that over time DRM controls will be relaxed and, whether via a registry or not, a more fluid and open system will mature. Nevertheless, that new system has to presuppose adequate security protections enabling the monetization of content; while the relaxation of DRM restrictions for music was enabled in part by the relatively secure and closed iTunes ecosystem, video has evolved into a hodgepodge of sales, access, and distribution points where each distributor needs assurance that users will have to pay for their content. Namely, content

providers and distributors want to restrict their concerns to how to tier those fees (sooner, later, limited, forever), not whether they will get paid at all. Accordingly, a new security industry is growing, implementing DRM systems (e.g., Microsoft's PlayReady, Google's Widevine) with third party specialists (e.g., Irdeto) adding additional encryption and security layers to bolster protections for the most highly prized content offerings.

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

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

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

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

Common Platform — Behind the Scenes Accelerant

Not much seems to have been written about this factor, but simplicity and common platforms have been essential to the areas of explosive growth of accessing and viewing video content via the Web. The case of iPods is well documented in the download space, but what beyond the concept of YouTube led to the exponential growth of streaming video? Other companies, such as iFilm, had been around for years with similar aspirations, but were

leapfrogged by YouTube. Why? Arguably, part of the answer was the compelling nature of YouTube coupled with both mass market high-speed Internet adoption (whether by DSL or cable) and use of common browser-based players. In the Web 1.0 days there were “player wars” with Real Player, Windows Media Player, and Apple’s QuickTime fighting to become the de facto standard. As video on the Web grew, spurred by YouTube’s rise, Macromedia’s Flash player seemed to gain dominance, with most users seamlessly adopting newer improved versions (e.g., Flash 7) to watch online video. Flash was becoming standard, and while companies routinely transcoded source material fewer were actively supporting multiple platforms—until, of course, a few years later Steve Jobs denigrated Flash and famously introduced the iPad without any ability to play/support flash files (Apple continuing its strategy of scoffing at the notion of common platforms and instead innovating a closed, and what it perceives as superior, integrated ecosystem).

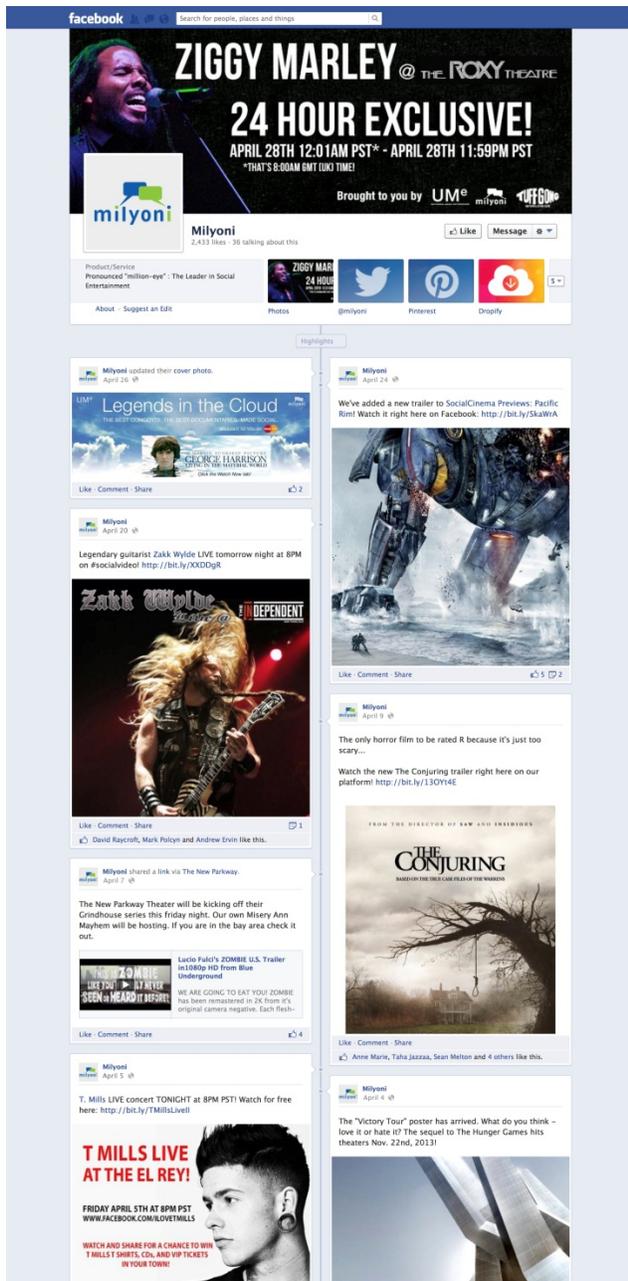
A Landscape Changed Virtually Overnight by iPods

Given the more recent launches and phenomenal success of the iPhone and the iPad, it is easy to forget how revolutionary the iPod was for video.

Although Apple did not break down statistics within the video category, or even what number of video-capable iPods were sold relative to all iPod purchases, it did confirm the following facts after the product’s 2005 launch: (1) there were 1 million video downloads in the first month, (2) there were 8 million video downloads in the fourth quarter 2005 post launch, and (3) there were upwards of 4 million video downloads in the first month of 2006. By September 2006 the *Hollywood Reporter* quoted Steve Jobs boasting: “In less than one year we’ve grown from offering just five TV shows to offering over 220 TV shows, and we hope to do the same with movies ... iTunes is selling over 1 million videos a

week, and we hope to match this with movies in less than a year.”¹¹ This adoption rate is staggering when compared to the growth, for example, of Netflix, which was the most successful Internet-based method of acquiring video content to date before the iPod (though Netflix at that point in time was not a download service, but a hybrid using Internet ordering like Amazon to then ship physical goods [rental DVDs] via the mail). Netflix took roughly 3 years to reach its first million subscribers, and another couple of years to reach 3 million (admittedly, not an apples to apples comparison given downloads vs. subscribers).¹⁴ Further, the iPod adoption rate was remarkable given the relatively limited amount of content available. While the iPod for music launched with a catalog of thousands of songs (and to the consumer, a catalog of content crossing the spectrum of virtually all labels, genres, and major artists), the iVideo application launched with a handful of TV shows, including ABC hits *Lost* and *Desperate Housewives*, and shorts from Pixar. (Note: It was this cooperation between Apple and Disney, with *Desperate Housewives* being the top property available to launch the iVideo application, that was among the factors turning the much played out saga of the Disney–Pixar distribution negotiations back onto a positive track, before ultimately quickly shifting direction and leading to the January 2006 announcement of the \$7B+ acquisition of Pixar by Disney. Digital distribution was for real, Steve Jobs was perceived as the industry’s guru, and in one stroke Disney regained its animation market pre-eminence as well as gained Jobs as a key shareholder and board member to help steer them into the digital future.) Not surprisingly, competitors rushed to the market, and the era of on-the-go video was launched, even though the smart phone and tablet markets which we view today as commonplace had not even been invented. It is a testament to the pace of technology, especially as it relates to video-based content, that in my first edition I could focus on how the iPod had revolutionized the market, and that less

than five years later the video iPod as a stand-alone device is no longer a driver of digital viewing.



(Image reproduced by permission of Milyoni)

Limited Studio Attempts to Make the Download Market

Recognizing the potential of the market and the need to have legitimate platforms to

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

While pioneers in providing a legal option for movie downloading, neither of these services — both hampered at the time by slow download speeds and starting up during the heyday of the peer-to-peer services that were eventually shut down by the Grokster decision — caught on and adoption remained limited. Whether the problem was functionality, piracy, pricing, or available content does not matter, as part of the early strategy was for the studios to simply show they were offering a legal alternative to pirate peer-to-peer sites. In the end, with the platform showing increased promise and piracy curtailed, MovieLink was acquired by Blockbuster in the summer of 2007 to provide its download solution.¹⁰

Types of Internet Advertisements and Relative Value

Among the many types of online advertisements, the oldest and most common are banner ads, which are bought and programmed in standard pixel sizes. For example, there may be rectangles (e.g., the ubiquitous 300 - 250 unit) or a vertical box on the side of a page (a “skyscraper” ad). With the advent of video content there has been a corresponding growth of video advertising. It is assumed that just as with television, a video commercial will be more compelling than a static banner advertisement. Given the nature of the Internet, including the trend for content to be delivered in shorter segments, video ads often come in short increments

such as 15 seconds (though there are certainly 30-second and longer spots as well). More important than length, though, is placement. Where such advertisements are placed may be more critical online than with respect to TV because of the shorter Internet attention span and tendency for users to move on quickly (taking the concept of channel surfing to a new level); accordingly, services continue experimenting to try and ascertain what mix of pre-roll, interstitial, or post-roll advertising optimizes viewing and therefore monetization.

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

The methodology of capturing engagement can also vary, with the historical valuation method linked to traffic. Traffic, however, can be differentiated by impressions and unique users. Advertising rates (such as banners) tied to impressions are a less exact measurement of a user’s engagement than tracking what that user did, what exactly they watched, how long they

watched, and whether their viewing then led to another activity (such as a related purchase, where conversion percentages are tracked). If what the user does (conversion ratio) is the critical value, such as in a search engine where people buying advertising care about users clicking through to their site via their advertisement (consuming or even making a purchase), then a cost-per-click model will likely be utilized. As the metrics improve and advertisers become more savvy, the media buys are being more closely crafted to pay out on actual results.

Exclusions: Frequency Caps and Out of Market Traffic

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

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

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

All of the previous discussion deals with the revenue side of the advertising equation,

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

Available Inventory

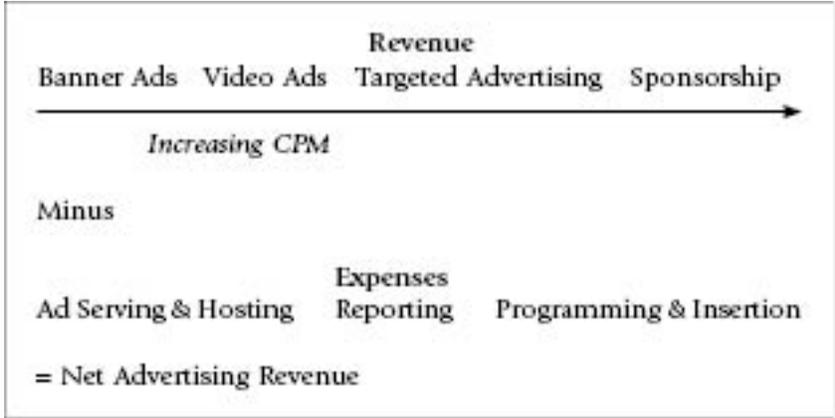
The final element in the advertising matrix is inventory, and who is authorized to program what, and when. Everyone wants to “sell out” their available inventory of space at the highest CPM rates, but in practice just like other media (e.g., TV) there are higher and lower performing sections of sites — a fact exacerbated by many sites being hundreds of pages deep. A site owner’s goal is to maximize sell out, and also maximize the value of key real estate. Key real estate may be the home page, and for video-based content may be the landing pages for the content, and the pages/areas surrounding the player through which the video is seen. To sort through this maze, a site’s ad/sales department will work to set up a waterfall of options, frequently contracting with multiple third-party advertising sales companies and networks. One

party may have the right to sell video advertising inventory, and another banner advertisements. Similarly, one party may have the first right to sell a space, but it may then default to someone else if either inventory remains or they have not secured advertising for inventory X with minimum established CPM thresholds. At the bottom of the waterfall will be “network” or other advertising which carries a lower CPM, but can be placed to fill remaining inventory (often referred to as remnant inventory). If space still remains then the site may elect not to include advertising or to run “house ads” cross-promoting its products and services (and certain amounts of space may be reserved for house advertisements in premium sections for promotion in the same manner that TV networks run commercials to promote their own shows).

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

Table 7.3 summarizes the continuum of values and how the P&L works:

Table 7.3 Continuum of Values/P&L



CHAPTER 8: Ancillary Revenues: Merchandising, Video Games, Hotels, Pay-Per-View & Transactional VOD Roots, Airlines, and Other Markets

VIDEOGAMES [See Chapter 8 of Book for discussion of Social Games]

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

Roughly 25 years ago, Universal tried to accelerate a game designed for the Atari 2600 tied to *E.T. the Extra-terrestrial* when the Steven Spielberg film was generating unprecedented buzz on its way to becoming a classic. The rushed time frame was commonly cited as the reason for the game's failure. Despite having only a matter of weeks to make the game, the *Los Angeles Times* chronicled that -hopes for blockbuster sales ran so high that there were more games manufactured than Atari consoles. More than 1 million cartridges wound up being dumped in a New Mexico landfill, and the fiasco was blamed for helping spark the 1983 crash of the videogame industry.⁹

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

- A game must still be good in and of itself, including game play
- A game can take more lead time than a movie to develop, produce, and publish
- A game is a different type of product which is fundamentally interactive versus a movie which is inherently passive

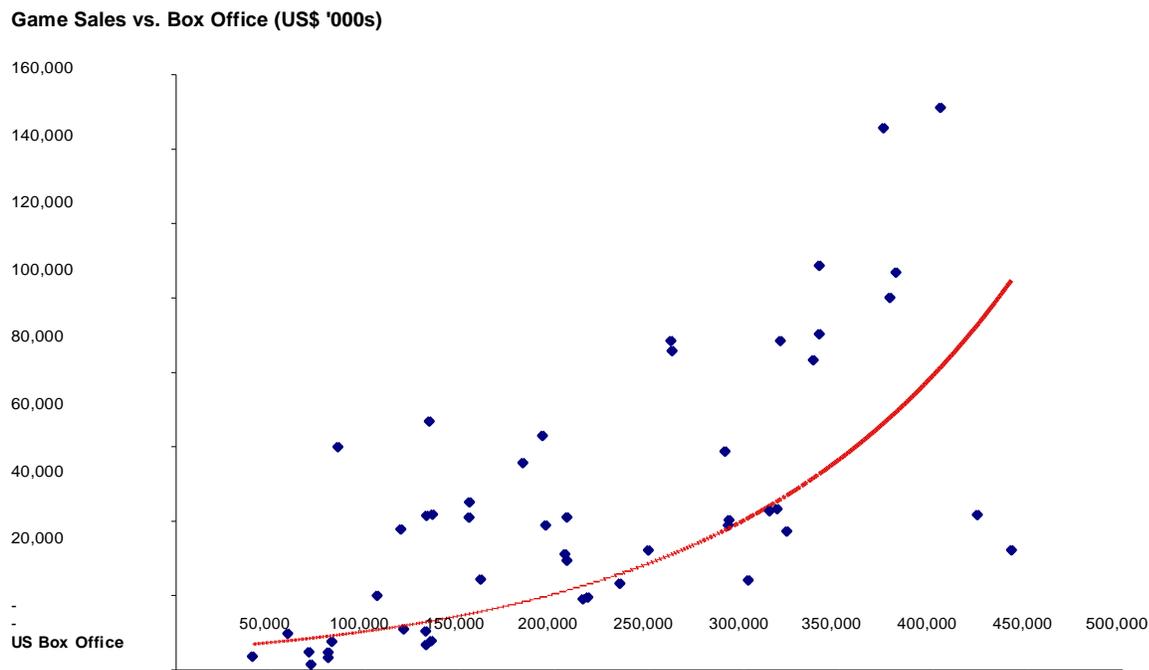
- Not all properties lend themselves to good games

Each one of these points is critical, and failure to address any one can undermine a game's success. What makes a game good is obviously subjective (games are another type of experience good), but to an extent this can be linked to the second point regarding the development period. The development and greenlighting of a game is not entirely dissimilar to the development process for any other type of story-driven piece of intellectual property. There needs to be a strong production team (lead designer, lead artist, lead technical director, producer, writer); a story that is appropriate to the medium (here, with appropriate levels of pay offs as opposed to more formulaic plot points in a film or TV show); and core characters, etc. (Note: Not all games are story-driven, so this analogy is limited.) To optimize results, time is needed, and a rush to production in a game is as dangerous as any other medium, especially given the added complexity of technical advances, the challenge of designing for multiple platforms (e.g., Playstation/X-Box/Wii consoles, PCs, downloadable), and the need to hit platform cycles as new hardware is introduced. (Note: In terms of marketing, the games industry often provides free demo versions. These demos of limited game play or certain levels provide a teaser to address the experience good quandary — not knowing if you like a product until you have consumed it — and add a key element to the arsenal of inputs beyond reviews, trailers, and advertising.)

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

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

Figure 1



Sources: NDP Group, Boxofficemojo.com, and CEA Autumn Games; includes only games released within film release window.

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

Table 1

| | US Game Revenue¹ (_000s) | US Box Office² (_000s) | Simultaneous Game and Film | Theatrical Release Date |
|--|--|--|-----------------------------------|--------------------------------|
| <i>Spider-Man: The Movie 2</i> | \$143,748 | \$373,600 | Y | 6/04 |
| <i>Lord of the Rings: Towers</i> | \$102,880 | \$339,800 | Y | 12/02 |
| <i>Star Wars: Episode III</i> | \$101,021 | \$380,300 | Y | 5/05 |
| <i>Lord of the Rings: Return of the King</i> | \$94,237 | \$377,000 | Y | 12/03 |
| <i>Finding Nemo</i> | \$82,562 | \$339,700 | Y | 5/03 |
| <i>The Incredibles</i> | \$80,716 | \$261,400 | Y | 11/04 |
| <i>Transformers: The Movie</i> | \$80,699 | \$319,200 | Y | 7/07 |
| <i>Harry Potter: Chamber of Secrets</i> | \$78,007 | \$262,000 | Y | 11/02 |
| <i>Spider-Man 3</i> | \$75,484 | \$336,500 | Y | 5/07 |
| <i>The Godfather</i> | \$57,177 | \$133,700 | N | 3/72 |
| <i>Madagascar</i> | \$53,370 | \$193,600 | Y | 5/05 |
| <i>SpongeBob Square Pants — The Movie</i> | \$50,325 | \$85,400 | Y | 11/04 |
| <i>Harry Potter: Goblet of Fire</i> | \$49,094 | \$290,000 | Y | 11/05 |
| <i>The Simpsons</i> | \$44,099 | \$183,000 | N | 7/07 |

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

[Note: The following several pages tied to Chapter 8, discussing various elements of the video game industry, have not been updated since the 1st Edition. Budget ranges have changed, Microsoft and Sony have announced new “next generation” versions of their respective Xbox and Playstation platforms (e.g., Xbox One), and the industry has experienced a measure of upheaval, including from the disruptive forces of free-to-play social games, streaming game services, and app based casual games. Accordingly, the balancing pages tied to Chapter 8 should not be relied upon as a current snapshot, but nevertheless provide some historical perspective in terms of pricing trends and early phases of market evolution.]

If we pose the more detailed question of what types of games based on movies do the best, not surprisingly the answer is that success is linked to a fan base that goes beyond an individual movie. Commenting on the same general data as above, *Games Business Daily* notes: A quick look at the top 10 movie game titles since 2001 shows that all of them were based on enduring properties with an active fan base long before the film released. Original sources included comics (Spider-Man), books (*Lord of the Rings*, Harry Potter) and existing popular film franchises (*Star Wars*, *Matrix*, and Pixar films).¹⁰ This line of reasoning seems to validate the notion that certain film-based video games are classic merchandising elements, less dependent on the unique elements of the game than driven by the franchise juggernaut.

Game Development Costs/Budgets

Product development costs can be all over the map, but one fact that is clear is that costs continue to rise with each new generation of gaming platform(s). Average development costs for older gaming systems (e.g., PS2), tended to be in the \$4–5M range, with occasional spikes, but it can now cost multiples of these sums (e.g., \$20–30M) for so-called next generation console

systems (e.g., X-Box 360, Playstation 3). Marketing costs, similar to film, have continued to rise with production costs, and companies in select instances may now spend sums nearly equal to production budgets (e.g., up to \$25M, with multimillion dollar marketing budgets now standard for all major releases).¹¹ With these budgets, the games business is starting to mimic the film business in looking for proven concepts, which (1) points again to licenses tied to franchise properties, and (2) raises the stakes for the distribution challenge (like with DVDs) to secure appropriate retail shelf space and retail-level promotion.

Additionally, a bit like films, there are now tentpole-like games that break the artificial, yet already high budget ceiling. With teams that may reach one hundred people working for multiple years, an investment in a property like a Halo sequel can theoretically be a multiple of these costs. Publishers are taking these risks because the upsides are now extraordinary as well: Halo 3 generated upwards of \$300M in its first week of release in 2007, with that record soon shattered in April 2008 with the \$500M first week of Grand Theft Auto IV.¹² People are now starting to wonder what the limit is, with Activision's Guitar Hero franchise generating greater than \$1Billion in a couple of years since its 2005 launch.¹³ Given spiraling costs, increasing inventory management issues (with higher volumes), and upsides justifying ever increasing marketing budgets, it is natural to point to how the games business is evolving to resemble the film business--with one critical difference. Whereas the film business has evolved multiple windows and ancillaries, games sales are still predominantly dependent on one version. Virtually all success depends on initial retail sales, with no video cushion or other ancillary markets customarily available to buffer underperformance.

ECONOMICS OF THE GAMES MARKET

[REMINDER: As noted above, this section has not been updated since the 1st Edition, and

accordingly does not take into account trends and segments such as free-to-play and social games]

It is beyond the scope of this book to cover the economics, marketing, and distribution of games, but given the convergence space and size of the video game market, the next section is a brief overview of the basic structure of pricing and sales.

Platforms

There are basically four categories of games: console, PC, downloadable, and massive multi-player online (MMOs).

MMOs as networked games can be extremely expensive to develop (even rumored to surpass \$100M), and are the highest risk category because there are only a handful of truly successful implementations. However, when they work, the returns may be the greatest of any entertainment property ever created. Blizzard Entertainment's World of Warcraft (now owned by Activision) has estimated subscriptions yielding more than \$1B *annually*. Although this seems unfathomable, with several million subscribers paying \$15/month the numbers add up, and *Business Week* reported that in 2007 the title generated revenues of \$1.1B with margins of more than 40% creating \$520M in operating profit.¹⁴

Although World of Warcraft is an almost cult-like phenomenon and it is not fair to compare it to the balance of the market, one general advantage to MMOs are that marketing costs tend to be lower; this is in part due to the viral nature of the market, and because of the ability to market directly to consumers online and bypass expensive and often inefficient retail campaigns. How much decreased marketing costs translate into higher margins is unclear, as the savings are at least in part offset by ongoing maintenance and infrastructure costs.

Historically the games categories included consoles (e.g., X-box, Playstation) and PC

formats with downloadable games a relatively new entry. Although one would hypothesize that PCs would engender successful games, that has not generally been the case; PCs tend to be a smaller or after-market, with most games developed for console systems. Why this is the case is not obvious, but stems in part from the almost cartel nature of the console manufacturers (which secure the top developers for their hardware and put huge marketing dollars behind games to drive hardware sales) and that consoles, built solely for game play, tend to lend themselves to better gaming experiences (with better graphics, etc.) therefore attracting top developers. At some level there is pure vertical integration with hardware manufacturers doing everything in their power to keep the best games captive to their systems: imagine if the studios owned the DVD hardware and you could only watch a studio movie on a DVD system (actually, this example is not so farfetched).

A Very Brief History of Consoles

The current battle among Nintendo (Wii), Sony (Playstation 3), and Microsoft (X-Box) is simply a variation on a battle for market share that has been playing out with each new iteration of console system launched over the last 20 years. There are a few systems relegated to the archives, with Atari and Sega among the early leaders who have not managed to keep pace. The evolution has been mostly about memory (RAM) and processing power with Nintendo evolving from 8 to 16 to 32 to 64 bit systems and most recently to the Wii (which is a break with tradition and seemed to come out of nowhere, a brilliant innovative twist to create a new experience instead of competing on the basis of memory and graphics capacity). With each new system, the ante is raised for quality, speed, and market share. Development costs on early console systems of \$1M could be high, but to keep up with the Joneses in the new millennium it was not uncommon for development costs on the new generation of platforms—at that time

Nintendo's Game Cube, Sony's PS2 — to cost upwards of \$10M. As noted previously, costs on the next-next generation (i.e., current) can be double that amount, and there has been a winnowing out of players that have been able to invest in the most state-of-the-art platforms (which have graphics power beyond what computers of the prior generation's age could perform). To recoup the cost of developing new systems, the hardware manufacturers charge developers for a –development kit to program games that will work on the consoles. These too have been spiraling up in cost and can run thousands of dollars per programmer.

Beyond the license costs to develop software for a console platform, any developer is required to manufacture console units via the hardware manufacturer (often referred to as a first party), which can cost several dollars (e.g., \$7+) per unit in license fees. While this defeats the open market that has worked over time to drive down the cost of manufacturing DVDs and videos, arguably there are rational and tangible economic benefits to the manufacturers for keeping this cost comparatively high and constant. First, assuming they keep a healthy margin from the manufacturing fee — again, a fair assumption if one were to assume that the cost of manufacturing the physical disc should not be that much more than the cost of replicating a DVD — this money helps recoup the R&D cost of developing new platforms. Second, and arguably more important, the captive nature of the consoles and requirement of exclusive manufacturing via first parties, helps to significantly curb piracy. [Note: Piracy, regrettably, has caught up with the games industry too. Publishers are starting to reserve a portion of game content for online distribution, allowing free downloads to users whose games it authenticates before sanctioning the download, thereby helping to curb piracy. Electronic Arts (EA) utilized this strategy with its summer 2009 release of Sims3, reserving an entire city (about one-third of the game's content) from the packaged goods version that could be downloaded for free

once the online key authenticated the game was a legitimate copy.]¹⁵

Given the regular increase in computing power, and its ability to enhance graphics, the games industry has developed a consistent rhythm of launching new hardware every few years (e.g., 5–7). This puts the pressure on to develop the next generation (e.g., 64 bit when 32 bit is out) almost as soon as the current system is debuted. Of course, the downside to this is the marketing and other costs of encouraging consumers to buy a whole new system (which are expensive to begin with, often more than \$200, and more expensive with each new iteration) plus the problem of retail management (people waiting to purchase a system, knowing a new and better one is just around the corner). Because of the cost of the new consoles, the market is dependent on holiday sales, and if hardware is not ready by Thanksgiving then the console is likely to fall behind until the next year materially impacting software sales, which are hurt by the double blow of delayed console units and marketing.

Developers therefore need to bet on when new systems will launch, and what will be a success, for unit sales necessarily correspond to the applicable installed base. (Remember the previous example where more units for the ET game were made than console units manufactured to date?). This creates havoc with timing, because developers not only need to become expert on new systems, creating games leveraging the capability of the new console before the consoles hit the shelves, but they need to hit the correct timing and platform. In the most recent incarnation of platforms, most expected Sony to maintain its market share edge gained with the PS2, but the PS3 was late in launching (almost a year behind the X-Box 360 in material quantities) and Nintendo's Wii took the market by surprise. Given spiraling costs, slower adoption of high-priced consoles, and the growth of online downloads, few today are talking about the next console platform; attention is now focused on enhanced digital

permutations, online-offline linked ecosystems, and new monetization streams such as micro-transactions and in- game advertising.

Mass Market Maturity and Movie-Like Revenue Potential

The good news is that despite the vicissitudes of the market, and dips every few years with the advent of new competitive platforms, the size of the overall market continues to grow, holding upside rewards for those that make great games and time the market well. In the early days an 8-bit game selling 100,000 units was a hit, while the target to be considered a hit grew to a few hundred thousand by the next couple of generations. With the so-called next generation systems such as X-Box and PS2 it was possible to sell more than 1 million units (with the installed base of PS2 for example reaching more than 100 million units worldwide), and today hit games such as Grand Theft Auto, Star Wars titles, Madden Sports titles, Guitar Hero, and Rock Band can sell in the multiple millions.

Unit sales are further enhanced by international markets which, similar to the DVD market, have matured such that international sales can now equal US totals. Additionally, games can cross platforms, and may be developed in tandem for a multi-platform release or, once launched and a success, may be adapted for release on a competitive platform. A version that is created for another console system, which may be developed by a specialist in that system, is referred to as a port in the games industry. (Note: As systems have become more complex, developers may specialize on a single platform to optimize investment and performance.) The concept of ports and the desire to have key titles either exclusively or for an exclusive window to drive hardware sales sometimes leads to console makers offering incentives, sometimes including guarantees or exclusivity payments, to developers.

Games Sales Now Bigger than DVDs

Given the previous numbers, combined with the decline in overall DVD sales (as discussed in Chapter 5), it was not surprising to see that in 2008 videogame sales for the first time ever surpassed DVD sales to pace the overall packaged entertainment market. Media Control Gfk reported that videogame sales increased 20% in 2008 to reach \$32B, compared to DVD sales which fell 6% to \$29B. The same research report predicted the trend to continue with games forecast to represent 57% of the pie in 2009.¹⁶ Given this trend, and the ability to sell games in the millions of units, the incentive to create and tie in game properties with film and television content is clear.

Despite the size of these markets, one of the more interesting questions in years to come will not be the relative percentage splits of games versus DVDs in the entertainment packaged goods space, but rather how electronic downloads grow and whether they cannibalize the packaged goods market or prove additive. Decline in sales will not automatically represent a decline in profits, as margins for electronic sell through are higher given the absence of inventory costs and problems, as detailed in Chapter 5. For margins to remain robust, however, price points need to hold, which will be the ultimate challenge for the games market whose average price per unit (as discussed in the next section) is now a multiple of that for the DVD market. For all the margin benefits electronic sell through promises, there is a dual danger of piracy once units are unshackled from the captive manufacturing by first parties and from price erosion if consumers come to more closely associate downloadable games with other downloadable entertainment software. (Note: As earlier discussed, digital piracy is countered by online play/authentication, which will be a major factor in maintaining a stable and robust market in the future.) Regardless of where these macro trends head, for the foreseeable future film and TV properties are likely to try and jump on the games bandwagon whenever possible.

Revenue Splits and Pricing

Games splits are akin to the video model, with prices set for consumers at retail (suggested retail price; SRP), and units sold into mass merchants and specialist accounts (e.g., Game Stop) at a wholesale price. Gross margin is then arrived at by deducting out costs of marketing, sales, and cost of goods from net wholesale revenues (i.e., net of returns). Table 2 is a sample of how the layers work:

Table 2

| Major Console | PS3, X-Box 360, Wii | Assumptions |
|----------------|-------------------------|--------------------------------|
| \$60 | SRP | \$49–59 range |
| \$47 | Wholesale price | 20–25% discount |
| \$ 5 | Marketing | ~10% of wholesale |
| <u>\$ 2.50</u> | Misc. other sales costs | ~5% |
| <u>\$39</u> | Gross margin pre COGS | |
| \$ 9 | Cost of goods | ~\$7-10, including first party |
| \$30 | Gross margin | Margin ex-development costs |
| <u>\$10</u> | Development costs | Variable allocation |
| \$20 | Net margin | Excludes overhead |

Similar to the video/DVD market, a developer’s share in proceeds may often be expressed as a royalty. The easiest number to take this from is the wholesale price, as akin to video all that needs to be tracked is the average price/unit and the net number of units sold. The royalty will then generally be expressed as a fixed percentage. In Table 2, a 20% royalty would result in the developer receiving \$9.40/unit, which if we assume ~\$20 net profit per unit equates to a revenue share of about 47% (9.40/20) versus the distributor share. This is not

dissimilar to the splits seen in the video market where (again as discussed in Chapter 5) royalties in theory may be set on sharing net revenues from a baseline of 50/50. (Note: The previous example is a simplification and therefore perhaps an overly rosy picture, as royalties will often relate to advances and be structured as a form of net post recoupment of investment risked.

Pricing and Markdowns

Videogames, which historically have been creatures of retail sales much like videos, tend to follow a rigid pricing model especially regarding console games. Games are initially priced at a high SRP, allowing high margins to recoup the significant manufacturing and R&D costs (in part built into the cost of goods with the first-party royalty). Initial price points, which will vary by platform, have therefore ranged from \$39.99 up to \$59.99.

As with DVDs, after an initial sales period at this high price, there is retail pressure to drop the price to move units once the sales trajectory slows and the average inventory of units in store creeps up from a few weeks to an unsustainable number (e.g., 20 weeks). Again, as with videos/DVDs, there is limited shelf space and new releases arriving, requiring constant jockeying as titles try to slow the migration from prominence to catalog placement.

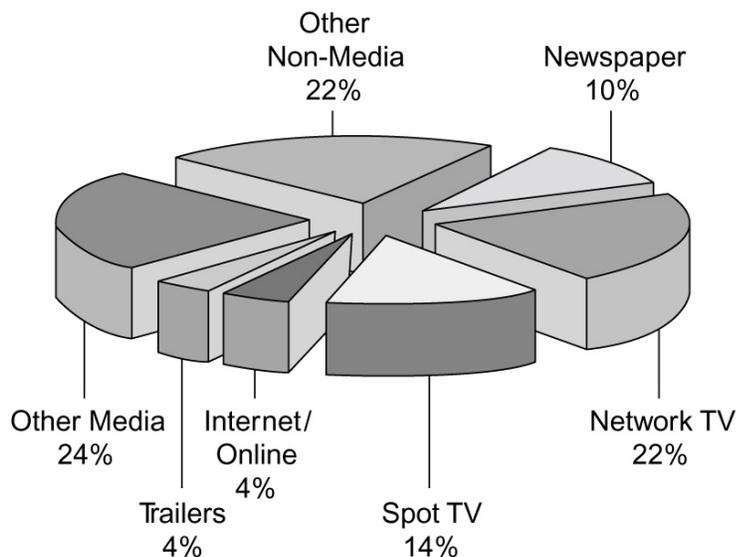
Whereas in the video world there are multiple markdown strategies, in the console videogame world there tends to be a more fixed pattern. Titles will often have one or two step downs, either to an intermediate price of \$29 or to a low price of \$19. Contrary to video, where the strategy is to slow downward pricing and an intermediate price point is apt to be favored, the hardware manufacturers in the console space have created incentives to bypass the interim step and move straight to the lower tier. X-Box has its Platinum program, and Sony its Greatest Hits for which titles need to qualify: if a title hits a certain unit threshold, then it qualifies for special

packaging within this branding, and the first party may discount its royalty to blunt the margin hit. Accordingly, the drop in price is associated with success, not failure, and with related marketing and retail push within this so-called elite sphere the uplift on sales can be very significant (e.g., 2:1). If a title does not qualify for a Greatest Hit or Platinum program, then it may make sense to hit the intermediate price of \$29; in this scenario, the first party may similarly reduce its royalty, and retail will respond to the incentive of lower price, but the likely uplift in sales will be much smaller.

Seasonality can significantly influence the rhythm of price reductions as well. Typically, for a holiday release which launches in the fall, there may be a drop in price to \$29 after Christmas (e.g., January) to clear out the channel and leverage gift cards and post holiday discount store traffic. Once this period is over, sales will trail off and the title can be re-priced down to \$19 in the spring or summer for a last push (and to remain competitive) as the title settles into its long tail of catalog sales.

CHAPTER NINE: Marketing

A 2010 study of Advertising by Medium from Kantar Media, a division of WPP, estimated that 73% of US theatrical marketing budgets were still allocated across different television media, while online spending remained close to 4% and newspapers well exceeded 10%. This would seem contradictory to the data regarding the growth of Online from Variety discussed in Chapter 9. The following is the Kantar breakdown:



(Source: Kantar Media. Note: figures are for the United States and theatrical releases only)

I am skeptical regarding the online and newspaper percentages, and again the challenge here may be comparing apples-to-oranges in terms of data samples; nevertheless, the trend showing that TV continues to dominate suggests that while online may start to cannibalize print and newspaper budgets, there is a long way to go before any sort of parity is reached with television.]¹

¹ [Kantar Media, *Movie Advertising Spending by Medium, 2010 (%)*, as reproduced in <http://www.marketingmovies.net/chapters/chapter-3-paid-advertising/>]

CHAPTER 10: Making Money — Net Profits, Hollywood Accounting, and the Relative Simplicity of Online Revenue Sharing

ADJUSTED GROSS AND ROLLING BREAKEVEN

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

Table 3: Adjusted Gross Example

| | 10% Distribution Fee | Zero Fee (0%) | Notes and Assumptions |
|----------------------|-----------------------------|----------------------|---|
| Box office (in \$M) | 200 | 200 | |
| Film rentals | 100 | 100 | Assume rentals @ 50% of box office |
| Distribution fee | 10 | 0 | |
| Print costs | 5 | 5 | |
| Advertising costs | 40 | 40 | (high) |
| Advertising overhead | 4 | 4 | Ad overhead @ 10% of advertising budget |
| Interest | 6 | 6 | Assume 10% of negative cost |
| Negative cost | 60 | 60 | |
| Overhead production | 9 | 9 | Assume 15% override cost of production |
| Profit loss | -34 | -24 | |

Breakeven Tricky to Capture

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

ROLLING BREAKEVEN

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

Table 4

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

**No additional costs and fees deducted since breakeven hit.*

***Additional costs included as break rolls.*

NET PROFITS MODIFIED BY OVER-BUDGET PENALTIES

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

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

Circumventing Net Profits:

Artificial Breakeven and Bonuses in Lieu of Profit Participations

Because of the complexity of calculating net profit participations, as well as the skepticism of participants as to whether they are being or will ever be treated fairly, alternative means of calculating contingent compensation have evolved. In the realm of animation, for example,

various studios/production companies have created –artist pools from which talent may share in profits. This is Hollywood’s version of profit sharing.

Box Office Bonuses

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

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

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

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

This type of compensation system is not as widely accepted because while it may seem fairer, the thresholds set are speculative and may in the end not correlate at all to actual profits. It is entirely possible depending upon costs, etc., that a payout could occur prior to real profits. Moreover, the notion of net profits is designed to share only in a certain pool, and to provide some buffer to the financing party, and any formula creating an automatic trigger could potentially be more costly to the funding party.

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

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

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

Sometime producers will have language such that their participation may be reduced, but then puts in floors that (1) ask the studio to share the burden of third-party participants after

a certain point (2) and/or puts a floor on the reduction such that the producer may not be reduced beyond this point.

Soft Floors

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

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

Table 5

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

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

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

believe there is an element of old boys club obfuscation, the real answer lies more in simple economics.

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

Hard Floors

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

PLETHORA OF ACCOUNTING STANDARDS/AUDITS

Understanding that there are multiple ways to calculate profits is half the battle. Much confusion and criticism can be diffused by grasping three different methods for calculating profits: in accordance with GAAP, based on tax accounting, and in accordance with contractual contingent compensation schemes (i.e., profit sharing). (Note: The following discussion is based

on general industry knowledge/practices — I am not an accountant and advise readers interested in this area to consult specialists or materials focused on the nuances of tax and related accounting policies and procedures.)

GAAP, Tax Accounting, and Profit Participation Accounting

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

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

Recognition of Income

The full value of a film license is often recognized in the first year that the license begins, thereby frontloading revenues from the asset. This is because the rules state that revenues

are to be recognized when (1) the film is complete, (2) there is evidence of a license agreement/sale, (3) the license period has commenced, (4) the amount of money due is fixed/clear, and (5) the ability to collect the fees/revenues is reasonably assured.¹⁷ In other words, if Studio X licenses the TV rights for the film in country X for a license fee of \$1M for a license term of 7 years, the \$1M is recognized as soon as the licensee rights to telecast the film mature (i.e., hold-backs have expired and the licensee has the right to start broadcasting the film).

Capitalizing Film Costs

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

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

Amortization of Capitalized Film Costs

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

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

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

Tax Accounting

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

text; however, I will offer a couple of thoughts.

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

Profit Participation Accounting

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

Audits and Online Differences

Accounting, at some level, is only as good as its verification. Because net profits are rarely paid, few participants actually audit; however, when a producer has a sizeable stake, audits are customary and all the intricacies and charges as previously discussed are scrutinized. This is the underbelly that exposes where all the revenue and costs truly lie, and without a doubt working on an audit of a box office hit can be the best education one obtains in the business. What is interesting in the growing online space is that audit rights are not always granted, and when they are there are few instances of actual audits taking place because the revenue at stake does not yet justify the expense (audits are expensive). As discussed in Chapter 5 regarding video, the complexity of tracking detailed costs, especially in foreign currency and on a pan- international

rolled-up basis, is part of the reason royalties are used rather than revenue-sharing models splitting the net. It will be interesting to see in the online space, when more revenue is at stake, whether companies will dissect revenue sharing (because the numbers are trackable), or whether assumptions will be enabled (again, the trust factor) to retain a simple percent/royalty structure when participants realize the extra costs and challenges to verify numbers.

Appendix A

BOX OFFICE BONUS PROFIT PARTICIPATION HYPOTHETICAL

Table 6

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