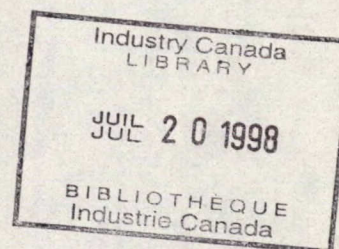


# STRATAVISION INC.

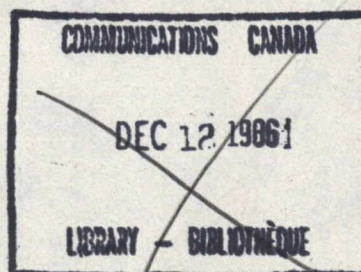
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## 1. THE STRUCTURE AND PERFORMANCE OF THE CANADIAN

### FILM AND VIDEO DISTRIBUTION SECTOR



Prepared for the Department of Communications  
October 4, 1985



A. Objectives

In a recent speech in Los Angeles, the Hon. Marcel Masse discussed the problems which are faced by Canadian film distributors and producers as a consequence of the US majors' practice of treating the Canadian market as part of a single North American market place. Citing the continuing failure of negotiations to produce practical solutions, the Minister stated:

"All negotiations must someday come to an end. I am obliged to report back to my Cabinet colleagues early in the Fall on the results of our discussions. We will, at that point, have to consider our options".

This study is intended to provide the background information and analysis necessary to assist the Minister, the Department and the recently announced Task Force in identifying and evaluating these options. It will focus on the current structure and performance of the distribution and exhibition sectors. In so doing, the study will:

- highlight the role played by distributors and exhibitors in the film and video market, focusing in particular on the economic relationships which exist between production, distribution and exhibition;

- describe and evaluate the current structure and performance of the Canadian distribution and exhibition sectors and the relevant segments within these sectors, identifying the key economic variables which influence this structure and performance;
- access the corporate strategies currently being implemented by various segments of the distribution and exhibition sectors; and
- identify the potential for change which exists in the industry as a consequence of these corporate strategies.



B. The Distribution and Exhibition Functions

The distribution and exhibition functions constitute the last steps in the series of economic transactions associated with the production and delivery of film and video properties. These functions are roughly equivalent to the wholesale and retail functions associated with any consumer market.

The distribution or wholesale function is the process whereby a particular film or video property is made available to exhibitors. It is triggered when the producer has a finished negative or video and is ready to release prints. This function may be divided into three components.

First, at the front-end, producers and distributors must establish a distribution agreement which covers the type of rights that are to be acquired by the distributors, the territory or territories within which these rights are to be operative and the distribution fee.

The distribution agreement usually grants to the distributor for some specified period of time the sole and exclusive right:

- " 1. to release, market and exploit the film throughout the territory using any methods or devices of exhibition, and, specifically, to distribute the film theatrically (in commercial movie houses), non-theatrically (in schools, clubs, universities and colleges), and by means of cartridge and video cassette;

2. to advertise the film by means of trailers of all sizes and gauges;
3. to sell the film to television (including pay television) either before, during, and/or after theatrical exhibition or in lieu of theatrical exhibition;
4. for the purpose of advertising and exploiting the picture, to broadcast on radio and television, by using living actors or otherwise, announcements concerning the film and dramatic episodes taken, based on, or adapted from the screenplay;
5. to publish dramatizations, novelizations and serializations from the property upon which the film is based;
6. to use excerpts from the literary property in heralds, programs, booklets, posters, lobby displays, press books and all other media of advertising and publicity;
7. to exploit commercial tie-ins by advertising the picture in association with some product, service or commodity (sweatshirts, toys etc);
8. to distribute the film in any and all languages throughout the territory." \*

These rights are exercisable within the territory or territories specified in the agreement.

The distribution fee may be set on either a flat rate or percentage of revenues basis. The percentage of revenues retained by the distributor will vary between territories and is based on the type of rights that are being exploited.

The second component of the distribution function involves the development of a marketing and advertising campaign based on

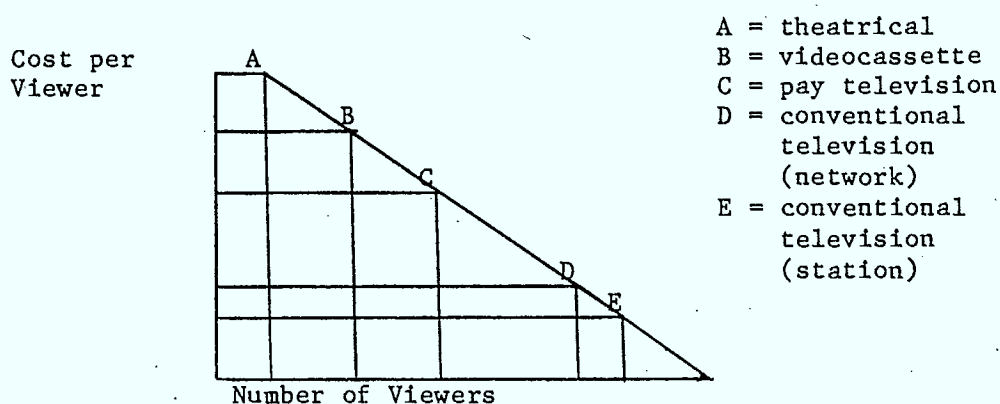
\* Garth Drabinsky, Motion Pictures and the Arts in Canada: The Business and the Law, pp. 146-147

strategies with respect to the theatrical release of the property, releases in other exhibition markets and the exploitation of any commercial tie-ins and related ancillary rights. In the development of these strategies, it is critical that the distributor accurately target the potential audience for the property and its expected "life" in each exhibition market.

For example, depending on the target audience and the expected life of the property, the distributor may develop a theatrical release strategy based on a preview screening followed by long first, second and subsequent runs. Alternatively, a distributor may opt for a quick release to all possible theatres or, for a more specialized product, may release the property only to selected theatres.

The release sequence between various exhibition markets may be modelled on a more specific basis. All things being equal, distributors will attempt to extract maximum revenues from their properties by releasing them in descending order of the per capita value attached to the property by consumers. As is illustrated in the following table, the normal distribution sequence begins with theatrical release at \$5.00 or more per capita and finishes with conventional television where broadcasters usually are willing to pay only a few cents per potential viewer.

Table I: Normal Distribution Sequence



The third component of the distribution function is the establishment of exhibition agreements, beginning with the theatrical licence agreement. It is through these agreements that the distributor attempts to implement his various advertising, marketing and release strategies, all designed to maximize the revenues generated by the property.

The theatrical licence agreement must not only determine the split of box office revenues between the exhibitor and the distributor but also, establish a formula for allocating the costs associated with the advertising undertaken by each theatre. Given the impact that the success or failure of theatrical exhibition can have on the revenue-generating potential of the property in all other subsequent exhibition markets, it is particularly important that the distributor reach theatrical licence agreements which effectively implement his strategies.

With these agreements in place, the exhibition or retail function commences.

In the theatrical market, the exhibitor derives revenues from box-office receipts and from confectionary sales. Clearly, the profit-maximizing objective of the theatrical exhibitor is to maintain continuous access to the type of properties which generate the greatest number of admissions possible, given the actual seating capacity of the theatre. This, in turn, will impact positively on revenues from the confection stand.

Exhibitors with multi-screen theatres have greater flexibility than single screen operators to the extent that they can adjust the actual number of seats that they devote to a particular property. In this sense, they can adjust the operation of their theatre to accommodate variations in the supply of mass-audience or more specialized properties.

In the videocassette market, revenues accrue to distributors from the sale of copies directly to retail outlets which, in turn, either sell or rent these properties to consumers. In the pay television and conventional television markets, revenues accrue to distributors based on a per-viewer charge. Exhibitors draw



revenues either from a monthly subscription charge or by selling air time to advertisers.

While it is clear, then, that the production and exhibition functions are important components of the process whereby film and video properties are delivered to their potential audience, the foregoing description also has highlighted the importance of the distribution function. This function has a major role to play in determining the success of any particular property and, in so doing, in shaping supply and setting prices in the market.

### C. Behavior in the Film and Video Market

In a perfectly competitive film and video market, the distribution and exhibition functions would take place as part of a series of independent, profit-maximizing transactions between individual investors, producers, distributors and exhibitors. The market would be atomistic, characterized by many small players with no economies of scale.

For distributors and exhibitors, such competition would result in a match between the quality and quantity of properties supplied and those demanded, at prices which allow all parties to make a profit. For consumers, such competition would result in access to properties in the context of a normal distribution sequence which satisfy their interests at prices which accurately reflect their intensity of demand.

However, even at a theoretical level, certain characteristics of the film and video market suggest that all players will face strong incentives to minimize risk and will, therefore, attempt to reduce the level of competition. Primary among these characteristics is the changing and erratic nature of final public demand for properties coupled with the long lead time associated with the actual production and delivery of a property. Such characteristics encourage all parties to make arrangements

to improve their access to downstream market information and to increase their control over, and access to upstream product.

#### Vertical Integration

For example, at the level of individual transactions, producers and distributors face strong incentives to establish distribution agreements in advance of the actual production of a property. For producers, such an agreement provides an additional source of investment as well as a guarantee of distribution once the project is completed. For the distributor, such an agreement ensures that he will have access to the property and, at the same time, allows him to influence the nature of the property based on his specialized knowledge of the way the distribution and exhibition markets are developing.

At the level of industry structure, advance distribution agreements may be formalized through direct vertical integration of production and distribution firms, as is the case with the U.S. Majors. Such integration is likely to occur where a single producer, by taking advantage of the economies of scale which appear to accrue from the operation of a large studio facility, is able to deliver a supply of properties of sufficiently varied quality and substantial enough quantity to justify the expense of maintaining a fully integrated distribution function.

In terms of the overall operation of the film and video market, the effect of such risk reduction agreements between producers and distributors is to prevent other distributors from accessing these properties and therefore, to reduce the overall competitiveness of the market. However, at the same time, it must be remembered that while such agreements may reduce the risk associated with certain upstream or downstream transactions, the overall level of business risk associated with a property remains a function of the ability of the distributor to evaluate it and to assess its market potential.

Arrangements to minimize risk also may be made with respect to the theatrical licence agreement. From the perspective of reducing overall business risk, these arrangements are much more effective than advance distribution agreements.

For example, distributors may establish exclusive arrangements with a group of exhibitors whereby the former are obliged to offer all of their properties to the latter, who are then obligated to exhibit them. Both parties benefit from these arrangements. Distributors are guaranteed exhibition for poorer quality properties on which they have made a mistake and which would not, therefore, command much attention in the free market. Exhibitors, on the other hand, while they must occasionally devote screen time to poorer quality properties, are guaranteed preferential access

to the "hottest" properties that a distributor has to offer at terms lower than those which might prevail in a competitive market.

The effect of these exclusivity arrangements is to substantially reduce competition in the marketplace. Exhibitors who might be prepared to bid on a particular property, but who are not included in the exclusivity arrangement, have no opportunity to do so. As well, distributors who have rights to a particularly attractive property may not be able to gain access to effective exhibition because screens are occupied with less attractive properties which exhibitors are required to carry under the exclusivity arrangement. Beyond this, distributors with assured access to exhibitors may be in a position to outbid other distributors for a particular property in the knowledge that they will be able to cover their bid through their exclusivity arrangement. Such outbidding is likely to take the form of larger up-front guarantees than those that can be given by smaller distributors without such arrangements.

Risk reduction at the level of the theatrical licensing agreement can be formalized through vertical integration between distribution and exhibition.

In this case, distributors with access to a sufficiently large and



diverse supply of properties may find it in their economic interest to directly enter the downstream exhibition market to allow them to better manage access by consumers to their properties.

Alternatively, a large multi-theatre exhibitor with substantial economies of scale could find it in his economic interest to reduce the upstream uncertainties associated with accessing a regular flow of the type of properties needed to operate his screens. Integration with a distributor should provide this exhibitor with substantially improved upstream information and with greatly enhanced abilities to plan and manage the flow of properties to his screens. In so doing, the integrated exhibitor-distributor is likely to experience a number of the economies associated with vertical integration such as reduced information gathering costs, reduced transaction costs and internal efficiencies resulting from the establishment of standardized administrative procedures in the context of stable relationships.

Beyond this, a vertically integrated exhibitor-distributor may be able to use this structure to significantly increase his access to properties. For example, to the extent that the exhibitor-distributor is confident of the box-office appeal of a particular property, he may be prepared to outbid competitors by

taking a smaller distribution fee and by offering a significantly larger up-front guarantee. Indeed, the vertically integrated exhibitor-distributor may be prepared to bid for a property to the point where the distribution function actually loses money, in the expectation that revenues from the integrated exhibition function will ensure that the company as a whole is better off than if the property had not been acquired at all.

Clearly, the impact of such integration and, in particular, of such integrated bidding practices, is to substantially reduce competition in the market place.

#### Market Segmentation

Another important characteristic of the film and video market is the large variation in barriers to entry. Significant barriers to entry exist in the area of production and exhibition. Both functions require substantial investments, either to assemble the rights and expertise to produce a property or to acquire the physical assets necessary to undertake exhibition. As such, substantial risk is associated with these functions. Entry into distribution, on the other hand, does not involve the same level of capital investment and hence, barriers to entry are lower.

Combining this information with the strong incentives which exist towards vertical integration, it seems likely that, all other things being equal, the film and video market will be characterized by a few large vertically integrated firms and a number of smaller non-integrated firms, with these smaller firms clustered in the area of distribution where barriers to entry are low. This non-integrated distribution segment will largely deal with particular niches of the film and video market which are not deemed sufficiently profitable to attract the attention of the larger players. Membership in this segment will vary over time as the large players use their market power to invade various niches once they have been demonstrated to be profitable by the smaller players. As well, players in the niche segment of the market are likely to face strong incentives to develop their own properties through pre-production deals or some form of vertical integration with a production firm as a means of maintaining a flow of marketable product and of defending themselves against the larger players.

However, niche players who manage to develop a strong vertically integrated position in the market and who, therefore, leave the niche market, are likely to substitute away from production towards exhibition using their new market power rather than pre-production investments to maintain access to a steady flow of properties.

### Government Policies

Given the high degree of risk associated with the film and video market and the consequent propensity of all players to attempt to minimize risk, government intervention in the market place can substantially modify behaviour.

For example, direct public funding for certain types of properties, such as those that meet Canadian content requirements, may induce a greater supply of these properties by reducing the degree of risk associated with them. Alternatively, public funding for properties targeted to a certain segment of the exhibition market — such as Telefilm funding — may substantially modify the normal distribution sequence. With public funds available, properties may be produced which are suited only to specific exhibition markets in the expectation that such funding will help to ensure that costs are fully recouped.

D. The Structure and Financial Performance of the Canadian  
Distribution and Exhibition Sectors

The financial implications of exhibition and distribution agreements can be traced at the aggregate level through the structure of the Canadian film and video industry. The following data \* trace the flow of revenues from sector to sector, concluding with an overall representation of the operation of the industry in the years 1982 and 1983.

\* All aggregate data, except as noted, are taken from Statistics Canada Circulars, 1982 and 1983.



Motion Picture TheatresTable II: Number of Firms and Paid Employees

	1982	1983	% change
<u>Establishments</u>			
Regular	983	899	- 8.6%
Drive-In	270	261	- 3.4%
	-----	-----	-----
Total	1,253	1,160	-7.5%
<u>Paid Employees</u>			
Regular	10,455	9,357	-10.5%
Drive-In	2,689	2,354	-12.5%
	-----	-----	-----
Total	13,144	11,711	-11.0%

As Table II illustrates, both the number of establishments and employment in motion picture theatres declined between 1982 and 1983. The total number of paid employees declined more sharply (-11.8%) than the number of establishments (-7.5%), suggesting that the industry as a whole was becoming more capital intensive.

Table III: Revenues to Exhibitors (\$ X 10<sup>6</sup>)

	<u>1982</u>	<u>1983</u>	<u>% change</u>
Admissions	355	328	- 7.6%
Concessions	87	80	- 8.0%
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Total	444	408	8.0%

Table IV: Exhibitors Costs and Profitability (\$ X 10<sup>6</sup>)

	<u>1982</u>	<u>%</u>	<u>1983</u>	<u>%</u>	<u>% change</u>
Wages	88	20	86	21	- 2.3
Resale Goods	35	8	31	7.6	-11.5
Other	105	24	98	24	- 6.7
Film Rental and Royalties	144	32	132	32	- 8.4
-----	-----	-----	-----	-----	-----
Total Expenses	372	84	345	83.5	- 7.3
Profit	71	16	66	16.5	- 7.1

As tables III and IV illustrate, the motion picture theatre sector between 1982 and 1983 was characterized by declining revenues both from admissions and concessions and, in spite of a small positive adjustment in the ratio of profit to expenses, a decline in total profits on sales by 7.1%. As such, in spite of the shake-out of inefficient firms which seemed to be occurring, the industry continued to face a rapidly weakening level of performance.

More recent data from a study commissioned by the Societe generale du cinema du Quebec suggest that this decline has continued into 1984, at least in the Province of Quebec. In 1984, total admissions in Quebec declined by 2.9 million. As well, the total number of screens declined by 17.5% and the number of films exhibited declined by 20%.

Taken together these two factors -- a weakening level of financial performance and a shakeout of apparently inefficient firms -- suggest that, in the early 1980's, the Canadian exhibition sector was ripe for major structural changes.

In Table IV, the figures of \$144 million in 1982 and \$132 million in 1983 for film rentals and royalties represent payments to distributors. These figures which constituted 32% of all revenues accruing to exhibitors and 38% of all exhibitors' expenses reflect the large financial effect of the theatrical licensing agreement.

Table V: Performance of Theatres by Region (\$ X 10<sup>6</sup>)

	<u>Revenues</u>		<u>Expenses</u>		<u>Profit</u>		<u>Margin</u>	
	1982	1983	1982	1983	1982	1983	1982	1983
Quebec	78.9	83.4	71	70.3	7.9	13	10%	16%
Ontario	175.2	159	144.9	136	30.3	23	17.3%	14%
All Oth.	189.8	170	156.5	140	33.3	30	17.5%	18%

As can be seen from Table V, Ontario and Quebec constitute the major exhibition markets in the country, combining to exceed all other markets. Interestingly, 1982 appears to have been a particularly poor year from a profit perspective for the Quebec theatrical exhibition market. However, profits rebounded in Quebec in 1983, suggesting that theatres in this province were slightly slower in responding to overall trends in the industry than theatres in other provinces.

### Distribution

Table VI: Number of Firms and Paid Employees

	1982	1983	% Change
<u>Number of Firms</u>			
Canadian	95	95	- -
Foreign	<u>20</u>	<u>19</u>	<u>- 5%</u>
Total	115	114	
<u>Paid Employees</u>			
Canadian	429	490	+14.2%
Foreign	<u>267</u>	<u>266</u>	
Total	696	750	+ 7.75%

As Table VI demonstrates, the structure of the distribution industry remained relatively stable between 1982 and 1983 with Canadian distributors providing almost twice as many jobs as foreign distributors.

However, as Table VII illustrates, a substantial shift did occur between 1982 and 1983 in the sources of revenues accruing to distributors. The 12.3% decline in theatrical revenues as a component of total revenues is consistent with the overall downward trend in the number of admissions in the industry. At the same time, the 75% increase in revenues for pay television and video reflects not only the introduction of pay television in Canada but also, the beginnings of growth in the videocassette market.



Table VII: Total Distribution Revenues by Source (\$ X 10<sup>6</sup>)

	<u>1982</u>	%	<u>1983</u>	%	<u>% Change</u>
Theatrical	154.6	54.12	135	44.5	-12.3%
Free TV	91.2	31.9	98	32.3	+ 7.7%
Pay TV and Video	<u>39.9</u>	13.9	<u>70</u>	23.1	<u>+75.4%</u>
Total	285.7		303		+ 6.0%

Table VIII highlights the dramatically different impact of these trends on foreign and Canadian distributors.

For Canadian distributors, theatrical revenues declined by almost 30%, in spite of a 24% increase in revenues from Canadian theatrical properties. Revenues from free television increased by 22%. However, revenues from pay television and video increased by 133.5%, from 20.6% of total revenues in 1982 to 48.1% in 1983. The effect of this was to increase the dependence of Canadian distributors on non-theatrical revenues from 69% in 1982 to 83.5% in 1983. While this change in revenue flows may be attributed to the substantial increase in revenues accruing to distributors from pay television and video, it is also interesting to note that revenues from foreign theatrical properties declined by almost half (42%) in this same period.

For foreign-owned distributors, 1983 was little different from 1982. Total revenues and revenues from theatrical properties declined marginally, while revenues from pay and video increased by 12%. In both years, no revenues were gained from the distribution of Canadian properties. The distribution of foreign theatrical properties in 1982 and 1983 accounted for respectively 62% and 59% of total revenues.

Table VIII: Total Distribution Revenues by Source by  
Ownership and Type of Property (\$ X 10<sup>6</sup>)

	<u>Canadian - Owned Distributors</u>					<u>Foreign - Owned Distributors</u>				
	<u>1982</u>	<u>%</u>	<u>1983</u>	<u>%</u>	<u>% Change</u>	<u>1982</u>	<u>%</u>	<u>1983</u>	<u>%</u>	<u>% Change</u>
<u>Theatrical</u>										
Canadian	4.6	6%	5.7	5.5%	+23.9%	--	--	--	--	
Foreign	<u>19.4</u>	<u>25%</u>	<u>11.3</u>	<u>10.8%</u>	<u>-41.7%</u>	<u>130.6</u>	<u>62%</u>	<u>118</u>	<u>59%</u>	<u>-9.7%</u>
Total	24.0	31%	17.0	16.3%	-29.2%	130.6	62%	118	59%	
<u>Free TV</u>										
Canadian	5.5	7%	5.3	5.0%	- 3.6%	--	--	--	--	
Foreign	<u>26.6</u>	<u>35%</u>	<u>33.9</u>	<u>32.5%</u>	<u>+ 27%</u>	<u>59.1</u>	<u>28%</u>	<u>59</u>	<u>30%</u>	
Total	37.1	42%	39.2	37.5%	+22.1%	59.1	28%	59	30%	
<u>Pay TV and Video</u>										
Canadian	5.5	7%	13.1	12.6%	+138.1%	--	--	--	--	
Foreign	<u>15.1</u>	<u>20%</u>	<u>35.0</u>	<u>33.6%</u>	<u>-131.8%</u>	<u>19.3</u>	<u>9%</u>	<u>21.6</u>	<u>10.3%</u>	<u>+11.9%</u>
Total	20.6	27%	48.1	46.0%	+133.5%	19.3	9%	21.6	10.8%	
<u>Total</u>										
Canadian	15.2	20%	24.1	23%	+ 58.5%	--	--	--	--	
Foreign	<u>61.1</u>	<u>80%</u>	<u>80.2</u>	<u>77%</u>	<u>- 31.3%</u>	<u>209</u>	<u>100%</u>	<u>199</u>	<u>100%</u>	<u>- 4.9%</u>
Total	76.3	100%	104.3	100%	36.7%	209	100%	199	100%	
<u>% of Total Industry Revenues</u>										
		27%		34.4%			73%		65.7%	

Taken together Tables VI, VII and VIII present a particularly interesting picture of the structure of the distribution industry.

While there were a large number of distribution firms in 1982 (115) and 1983 (114), the industry was highly segmented. Twenty foreign-owned firms, or 17% of the industry, received 73% of the total revenues accruing to distributors in 1982 and 65.7% in 1983. Foreign-owned firms were highly dependant on the theatrical market for revenues in both years, while Canadian-owned firms appeared to be developing greater reliance on the television market as a result of both increased revenues in this area and the loss of revenues from foreign theatrical properties.

These financial results for Canadian distributors are consistent with the type of niche strategy that might be pursued by a weaker segment of the industry. However, it is interesting to note that, even for these distributors, foreign properties were the primary market instrument generating 80% of revenues in 1982 and 77% in 1983.

Table IX examines revenues to distributors by region. In this regard, it is interesting to note that while revenues to distributors in Quebec were less than 10% of those accruing to distributors in Ontario, the profit margin for Quebec distributors was substantially higher both in 1982 and 1983. This suggests that the distribution sector in Quebec has carved out a profitable niche which larger players have not yet, and perhaps, never will invade because of the barriers created by language.

Table IX: Revenues to Distributors by Region (\$ x 10<sup>6</sup>)

	<u>Revenues</u>		<u>Expenses</u>		<u>Profit</u>		<u>Margin</u>	
	<u>1982</u>	<u>1983</u>	<u>1982</u>	<u>1983</u>	<u>1982</u>	<u>1983</u>	<u>1982</u>	<u>1983</u>
Quebec	20.1	21.0	16.7	18.5	3.4	2.5	17	11.9
Ontario	204.6	230.0	185.1	210.9	19.5	20.0	9.5	8.7
Others	63.4	56.0	59.0	51.0	4.4	5.0	7.0	8.9



Table X illustrates costs to distributors in 1982 and 1983.

Table X: Costs to Distributors, by Ownership (\$ X 10<sup>6</sup>)

	<u>1982</u>	<u>%</u>	<u>1983</u>	<u>%</u>	<u>% Change</u>
<u>Canadian-Owned</u>					
Wages	11.4	14%	12.6	11.7	+10.5
Other	19.4	25%	34.8	32.2%	+79.3
Rentals, Royalties and Commissions	<u>40.4</u>	<u>51%</u>	<u>51.6</u>	<u>47.8%</u>	<u>+27.7%</u>
Total Cost	71.2	90%	99.0	91.7%	+ 39%
Profit	<u>7.8</u>	<u>10%</u>	<u>9.0</u>	<u>8.3%</u>	<u>+15.3%</u>
Total	79	100%	108	100%	+36.7%
<u>Foreign-Owned</u>					
Wages	6.9	3%	7.0	3.5%	- -
Other	52.7	25%	46.6	23.4%	-11.6%
Rental, Royalties and Commissions	<u>130.2</u>	<u>62%</u>	<u>127</u>	<u>63.8%</u>	<u>- 2.5%</u>
Total Cost	189.7	90.7%	180.6	90.6%	- 4.8%
Profit	<u>19.5</u>	<u>9.3%</u>	<u>18.8</u>	<u>9.4%</u>	<u>- 3.6%</u>
Total	209	100%	199	100	- 4.8%

As this table shows, rentals, royalties and commissions constitute the most significant element of the distributors' cost function, ranging from 51% of total revenues for Canadian-owned distributors to 62% for foreign-owned distributors. These payments constitute the financial component of the distributor agreement and totalled 170.6 in 1982 and 178.6 in 1983.

Table XI demonstrates the split in rentals/royalties and commissions between Canadian and foreign producers in 1982. Less than 5% of all payments were made to Canadian rights holders.

Table XI: Payments to Producers in 1982

	<u>To Canadian Copyright Holders</u>	<u>To Foreign Copyright Holders</u>	<u>Total</u>
By Canadian-owned distributors	7.7 (19%)	33 (81%)	40.7
By foreign-owned Distributors	----	129.9 (100%)	129.9
Total	7.7 (4.5%)	162.9 (95.5%)	170.6

More recent data suggest that these limited payments to Canadian rights holders may actually have grown smaller since 1982. As is set out in Table XII, based on this sample the box office grosses generated by all properties distributed by Canadian distributors decreased by 45%, from 11.9 in 1982 to 6.6 in 1984.

Coincident with this, the box-office revenues generated by Canadian films as a percentage of the box office revenues generated by all the films distributed by Canadian distributors decreased from 14.7% in 1982 to less than 3% in 1984. This suggests that the supply of Canadian theatrical properties dropped dramatically and that payments to producers must logically have followed suit.

Table XII: Recent Box-office Performance by Canadian and Foreign Distributed Properties \* (\$ X 10<sup>6</sup>)

<u>Foreign-Owned Distributions</u>	<u>1982</u>	<u>1984</u>	<u>%Change</u>
Total Box Office from all Properties	73.1	84.3	+15.32%
% of total box office generated by Canadian properties	---	---	
<u>Canadian-Owned Distributors</u>			
Total box office from all Properties	11.9	6.6	- 44.6%
% of total box-office generated by Canadian properties	14.7%	2.9%	- 80.3%
% of total box-office generated by U.S. properties	45.8%	77.5%	+ 69.2%
% of total box-office generated by Non-U.S. properties	39.5%	19.6%	- 50.4%

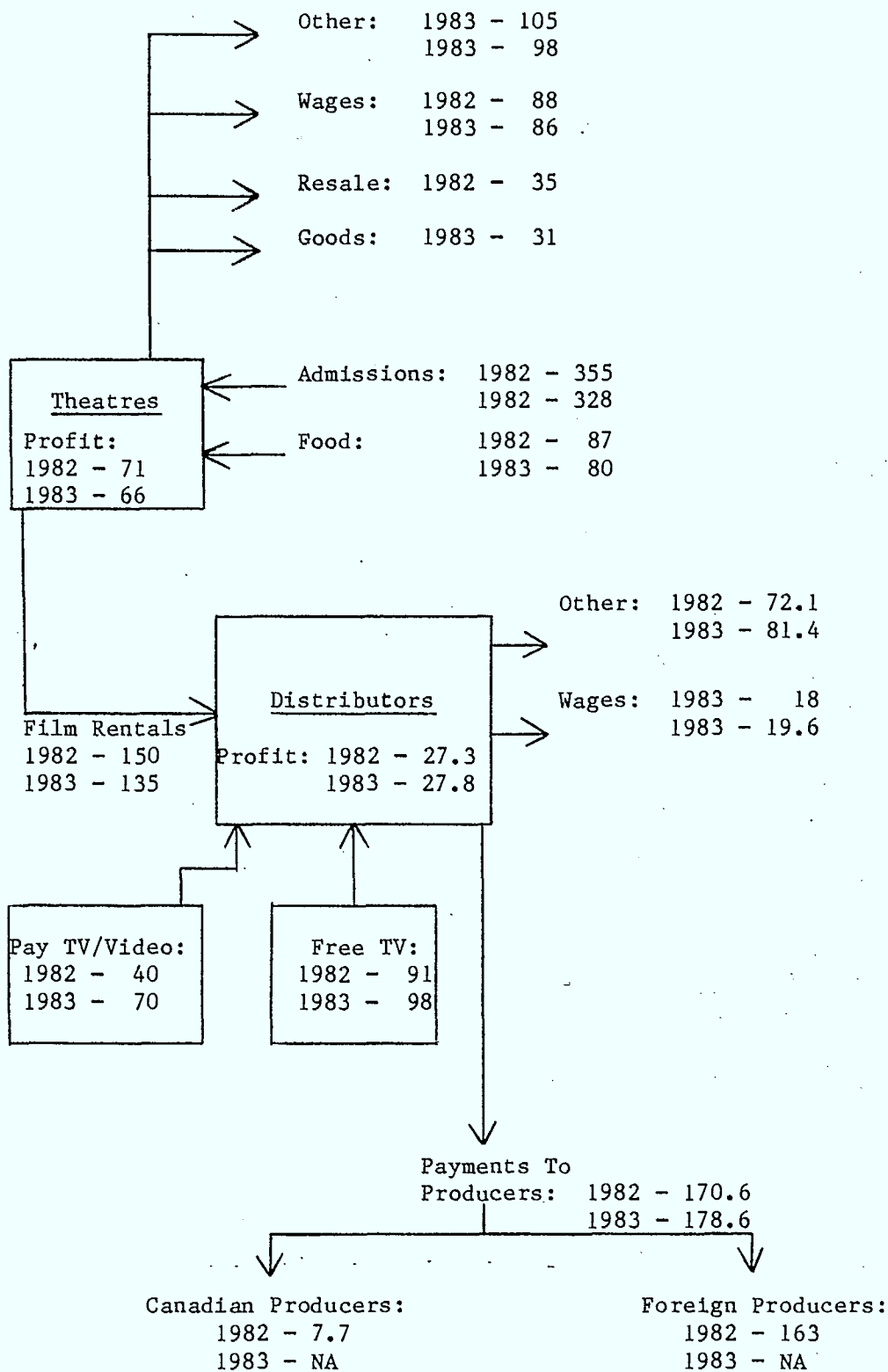
\* This data is based on box-office grosses published monthly by Cinema Canada. The list published by this journal does not claim to be comprehensive. It clearly is not comprehensive given that, for example, total theatrical revenues to foreign - owned distributors in 1982 were \$130 million.

Beyond this, the sample in Table XII illustrates the extent to which the theatrical market position of Canadian distributors was eroded between 1982 and 1984, with box-office revenues to U.S. distributed films increasing by 15.3% and box-office revenues to Canadian distributed films decreasing by 45%. While this may be due in part to the decline in the availability of Canadian films, it also may be attributed to a decrease in the distribution of non-U.S. foreign films by Canadian distributors. In 1982, these films accounted for 39.5% of the box-office revenues generated by Canadian distributors. In 1984, this figure declined to 19.6%, accompanied by a substantial increase in the dependence of Canadian distributors on U.S. films (from 45.8% of box-office revenues to 77.5% in 1982 to 77.5% in 1984).

### Overview of the Industry

Using 1982 and 1983 data, the overall performance of the Canadian film and video industry may be schematically represented as is set out in Table XIII.

Table XIII: Overview of the Industry



E. Corporate Strategies \*

The preceeding sections in this paper have examined the Canadian film and video industry from both a theoretical and empirical perspective.

The theoretical analysis concluded that, given the nature of the film and video market, substantial incentives to engage in risk-reducing behaviour are likely to exist. These incentives, in turn, will have structural implications leading to vertical integration, segmentation and a significant reduction in competition.

The empirical analysis of the structure and financial performance of the film and video market has confirmed a number of these conclusions and highlighted other trends. For example, the industry clearly does have a highly segmented structure which, based on identifiable revenue flows, is dominated by foreign-owned distribution firms. This dominance appears to have been maintained in spite of substantial changes in the sources of revenues in the market, such as those associated with the introduction of pay television in Canada. The empirical analysis also has identified a trend towards a very limited television - oriented niche strategy on the part of Canadian distributors since

\* This section is largely based on confidential interviews with members of the industry. A full list of those who were interviewed is included as an Appendix to this report

1982 and, at the same, a substantial increase in their reliance on U.S. theatrical properties as the supply of Canadian theatrical properties has decreased and, apparently, access to other foreign theatrical properties has become more difficult.

This section will use these findings to examine and assess the corporate strategies currently being implemented by each segment in the Canadian film and video market. In particular, emphasis will be placed on identifying the way in which these segments and their key players are responding to incentives in the market.



### U.S. Majors

The group of vertically integrated U.S. film production and distribution companies commonly referred to as "the Majors" includes Warner Brothers, Universal, MGM/UA, Paramount Pictures, Columbia Pictures, Twentieth Century Fox, and Orion.

Responding to the risk reduction incentives in their industry, the Majors very early established completely integrated operations, using their control of the major studios to extend into distribution and through to exhibition. Following the U.S. Consent Decree of 1948, when it was determined that such integration constituted an anti-trust violation, the Majors were forced to divest themselves of their control over exhibition firms. Henceforth, theatrical licence agreements were established through a bidding process involving all interested local exhibitors. Nonetheless, through their control over the production and distribution of mass market theatrical properties, the Majors have retained their dominant position in the market. As a consequence of recent financial transactions, which have seen many of the Majors acquired by larger conglomerates, the resources available to them to maintain their market position have been increased considerably.

As is illustrated in the empirical data set out in the preceding section, the Majors also occupy a dominant position in the Canadian film and video market, receiving almost 80% of all film rental payments from exhibitors in 1982 and slightly less than 70% in 1983. This position is based on a number of key factors.

First, the Majors are direct players in the Canadian market, supplying first-run, attractive, mass market properties. Consistent with the incentives to minimize risk by having easy access to down-stream market information through direct dealings with exhibitors, the Majors have tended to operate in Canada through wholly-owned subsidiaries. As such, there have been few opportunities for Canadian distributors to acquire the very attractive theatrical properties produced by the Majors. In addition, in one instance, a Major (Gulf & Western/Paramount) has taken a direct ownership position in the Canadian exhibition sector (Famous Players).

Second, while bidding was used for a short time in the Canadian industry to establish the theatrical licence agreement, the past and current practice of the Majors is to operate on an exclusive basis. As was set out in the theoretical discussion of the industry, such exclusivity arrangements can have significant risk reduction benefits for those included in the agreement. However,

these arrangements also can substantially reduce competition, creating barriers to entry for those not included in the agreement. In the Canadian market, exclusivity agreements can be seen as another important instrument used by the Majors to maintain their dominant position in the market.

Third, and perhaps most importantly, in all of their transactions the Majors treat the Canadian market as a part of the domestic U.S. market. While this is logical for those properties which they themselves have produced, and for which they hold world rights, this practice also extends to any domestic or foreign independent properties which they acquire. For both US and foreign independent producers, then, the price of accessing distribution by a Major in the U.S. involves selling to this same Major the rights for the property in Canada. In this way, the Major's powerful position in the U.S. market is used as leverage to maintain a dominant position in the market for independently produced properties distributed in Canada.

Most recently, as the Majors have adopted a more diversified release strategy by including a larger mix of independently produced properties, their ability to undertake leveraged acquisition has substantially reduced competition in the Canadian marketplace, foreclosing a significant supply of theatrical properties that were previously available to Canadian

distributors. It is this foreclosure which may explain the trends noted in the previous section where, between 1982 and 1984, the ability of Canadian distributors to access non-U.S. foreign properties appears to have decreased, dependence on marginal U.S. independent properties appears to have increased and total revenues to Canadian distributors from all theatrical properties have declined.

The development of a diversified release schedule remains a significant element in the Majors' current corporate strategies. The rapid evolution of such ancillary markets as pay television and home video has created new revenue - generating potential both for properties produced by the Majors and for the properties they acquire. Indeed, it is estimated that in 1985, almost 50% of all revenues accruing to distributors will come from non-theatrical markets. \* As such, potential revenues from these ancillary markets are now large enough to interest the Majors in properties which, given their likely draw in theatrical markets alone, would usually have been left to other distributors.

The current corporate strategies of the Majors in Canada, then, appear to involve two central objectives:

- i) to maintain or enlarge their dominant position in the theatrical market and, in particular, their current

\* Garth Drabinsky in a speech to the 1985 Trade Forum.

share of theatrical revenues through the continued use of leveraged acquisitions and wholly-owned Canadian subsidiaries; and

- ii) to use their ability to make leveraged acquisitions to extend their dominant position in the theatrical market into the home video market, focusing in particular on the acquisition of an ever-increasing supply of independent productions.

In the home video market, the strategy involves three activities. First, the Majors are now acquiring ancillary rights for those independent properties for which they might formerly have acquired only theatrical rights. Second, they are acquiring more independent properties than previously was the case, in the expectation that revenues from ancillary markets will justify their purchase. Third, consistent with a risk reduction strategy, they have expanded their direct distribution activities in Canada to include video properties.

The extent to which this strategy is proving successful is indicated in a recent study by Nordicity which estimates that "55% of all titles (5,000) and roughly 60% (of) feature films available in videocassette" are accounted for by foreign distributors. \*

\* Nordicity, Film/Video Retail Study, p. 18

## Cineplex

Cineplex is the only fully integrated player in the Canadian theatrical market. The firm consists of four operating divisions: Toronto International Studios which is Canada's largest production facility; Pan-Canadian which is Canada's largest independent distributor of commercial, arts and specialty films with exclusive Canadian rights to all properties owned by Embassy and to all movies released in Canada by Cannon; Kernels Popcorn, a gourmet popcorn manufacturer; and Cineplex-Odeon, a theatrical exhibition firm with approximately 450 screens in Canada. As well, Cineplex manages a number of screens in Los Angeles and has recently acquired over 600 more through its purchase of the U.S.-based Plitt exhibition chain.

The Cineplex organization began in the late 1970's, based on a very effective niche strategy. Excluded from access to the properties of the Majors by these distributors' agreements with Odeon and Famous Players, Cineplex developed a new exhibition concept designed to capitalize on the general lethargy that existed in the Canadian exhibition market and the potential shakeout that was looming in this sector as a consequence of declining theatre admissions. Identifying the art and specialty film market as under-developed, Cineplex either constructed new, or acquired and renovated older theatres based on a multi-screen

concept. With many screens operating under a single roof, Cineplex was able to capture significant economies of scale in its theatre operations and was able to make money on properties that were largely ignored by the two dominant chains.

In the 1980's, as the Majors began to adopt a more diversified release strategy, Cineplex began to feel the effects of foreclosure in its principal film market. In an attempt to gain access to properties and as a means of fighting back against the Majors, the firm encouraged the Director of Investigations and Research to begin a review of the exclusivity arrangements which existed in the industry. As a result of the uncertainties which this investigation produced and, in particular, the difficulties which were associated with the short-lived bidding process required by the Director, the Odeon chain became available and was acquired by the firm. Cineplex, then, had effectively bought its way into the exclusivity arrangement and to access to the properties of the Majors.

With a substantial increase in the number of screens under its control, Cineplex began to engage in rational risk-reducing behaviour. The attention of the firm was re-focused on exhibition through the new Cineplex-Odeon division and away from the production activities it had previously undertaken through Tiberius Productions. International Studios became merely a

facilities operation, made available to other producers on a lease basis.

As well, with substantial holdings in the theatrical exhibition market, it became particularly important that Cineplex have complete up-stream information and assured access to a wide variety of properties, including those supplied by the Majors and more specialized properties. Given this, Cineplex-Odeon acquired and began to expand the operations of its own in-house distribution company, Pan-Canadian. Again, this is consistent with the incentives to minimize risk which exist in the industry.

In the current environment, Cineplex-Odeon appears to be pursuing two inter-related strategies.

First, the firm is continuing its expansion in the area of theatrical exhibition. This is an area where the firm clearly has expertise and, with its new approach to theatre management, brings fresh ideas and insight into an industry which is experiencing some difficulties. The firm can take advantage of economies of scale and well-developed management techniques to breath new life into the exhibition sector. This clearly is the rationale behind the recent acquisition of the Plitt chain.

Second, in the area of distribution, the firm is using its



vertically integrated position to strengthen the role of Pan-Canadian in the Canadian market for independent properties and, in so doing, to ensure that its exhibition chains have access to prime independent products. As was set out in the theoretical section, an integrated exhibitor-distributor can generally outbid non-integrated distributors for properties because of its ability to make substantially larger up-front guarantees.

Indeed, it appears that the firm is taking this strategy to the extreme, exercising its integrated bargaining power against independent distributors who traditionally would make their properties available to Cineplex-Odeon exhibitors. Far from just ensuring increased access to properties, it now appears that Pan-Canadian/Cineplex-Odeon has decided to eliminate its reliance on non-integrated independent distributors by establishing Pan-Canadian as the exclusive supplier of independent properties to its integrated exhibition chain. While this is consistent with a risk-minimizing and profit-maximizing strategy on the part of Pan-Canadian/Cineplex-Odeon, designed to maximize the funds available for continuing expansion in the area of exhibition, it is likely to have serious negative implications for the remaining Canadian independent distributors.

ASTRAL

Astral also is a vertically integrated Canadian distribution firm. The firm distributes properties in the theatrical, television and videocassette markets, has a major position in the retail photo finishing market and an ownership position in the pay television industry. Astral, like Pan-Canadian, has sub-distribution agreements with U.S. distribution firms and has developed a significant position in the Canadian home video market.

In the past, Astral pursued an effective niche strategy based on a strong position in the retail photo finishing market, using this position to acquire a distribution firm and to enter into sub-distribution agreements. As well, Astral directly undertook a number of feature film productions.

However, most recently, consistent with a risk-reduction strategy, Astral has taken a major ownership position in the First Choice pay television service. While this service has an uncertain future, it does have monopoly status in the Canadian marketplace and is supported by an extensive protective regulatory framework designed to prevent competition and assure the service access to cable systems and subscribers.

As a condition of its acquisition of First Choice, Astral agreed not to become directly involved in film and program production. Given the incentives which exist to substitute away from production towards exhibition, this condition was most likely consistent with Astral's corporate strategy. However, the firm remains prepared to provide guarantees or bridge financing to producers, perhaps as a means of ensuring that properties will be available to it to meet the Canadian content quotas attached by the CRTC to its pay television service.

In the current environment, Astral appears to be pursuing two main strategies.

First, it is taking advantage of the video revolution to maximize the use of its technical facilities for the duplication of videocassettes. Duplicating facilities have now been established in Ontario and Quebec and Nordicity estimates that Astral, VTR Productions and Agincourt Productions collectively account for over 90% of videocassette duplications in Canada. Beyond this, Nordicity estimates that Astral is the largest Canadian distributor of videocassettes, accounting for 3.5% of all titles available in Canada.

Second, Astral is attempting to strengthen its position in the area of exhibition. It has applied to the CRTC for lower Canadian

content requirements and for part ownership of a new discretionary  
cable-delivered Family Channel service.

### Famous Players

Famous Players is the second dominant exhibition chain in Canada. It is owned by Gulf & Western, which also owns a vertically integrated U.S. Major, Paramount. In addition, Famous Players has exclusivity arrangements with other U.S. majors.

To date, Famous Players has pursued a relatively passive corporate strategy, relying on its exclusivity arrangements with its vertically integrated Major and other U.S. Majors to ensure that it has access to popular and attractive mass audience properties. However, most recently it has been rumoured that the firm intends to establish a distribution arm designed to play a role for it in the market for independent properties similar to that played by Pan-Canadian for Cineplex-Odeon.

This development suggests that Famous Players is preparing to adopt a more aggressive corporate strategy, perhaps changing the orientation of some of its theatres to capture a share of the lucrative arts and specialty film market currently controlled by Pan-Canadian/Cineplex-Odeon. Consistent with a risk-reducing and profit-maximizing approach, it may be most effective for Famous Players to implement this strategy through a vertically integrated distributor rather than through independent distributors. Such an approach would allow Famous Players to use

the full economic power of its exhibition chain in making competitive bids for properties.

### Canadian Independent Distributors

As the smallest and most fragmented segment of the industry, independent Canadian distributors have had to pursue very flexible niche strategies, subject to quick adjustments as the market leaders change their strategies.

In the late 1960's and early 1970's, independent distributors pursued three major strategies. First, they attempted to acquire independent properties, primarily exploitation films, for distribution to exhibitors during off peak times. Second, as a risk reduction initiative, they also became involved in the production of films as a means of guaranteeing themselves access to product, and, in the process, helping to shape this product. This was immeasurably assisted by CFDC requirements that funding for Canadian features be tied to participation in the film by a Canadian distributor. Third, independent distributors attempted to obtain sub-distribution agreements with British or U.S. distribution companies.

In the years since this time, a number of developments have taken place which have disrupted these three strategies.

First, as was noted earlier, the Majors have adopted a more diversified approach to distribution, substantially cutting into

the product available for independent distributors. As well, some sub-distribution agreements have evaporated as foreign firms have chosen to directly enter the Canadian market.

Second, the advent of the capital cost allowance for film production significantly reduced the importance of distributor participation in the front-end of the production of a property. This not only reduced the number of films to which Canadian distributors had automatic access, but also, precluded knowledgeable Canadian distributors from influencing the type of property that was produced. As such, while the supply of Canadian theatrical properties increased considerably, many were totally unmarketable. Of those that were marketable, many were offered to U.S. distributors as a means of gaining access to the U.S. market. The effect of this was to prevent Canadian distributors from undertaking important risk-reducing advance distribution agreements, and, in the end, to further reduce the supply of marketable Canadian theatrical properties available to them. The recent re-orientation of Telefilm towards television and away from theatrical properties has further contributed to this problem, bringing the Canadian theatrical market to a virtual stand-still.

Third, the emergence of Pan-Canadian as a powerful vertically integrated distributor apparently intent on acting as its own exclusive supplier of independent product has further reduced the



ability of smaller non-integrated distributors to compete in the market for the few remaining foreign theatrical properties that are available.

Squeezed on all sides, independent distributors face few options. Most niches have been invaded by foreign or vertically integrated Canadian distributors. While the Telefilm fund provides some support for a specialized niche strategy focused on television, such a strategy will entail essentially an abandonment of the theatrical and the potentially lucrative home video markets, at least in English Canada. At minimum, this will result in a significant reduction in the number of distribution firms in Canada, with major economic impacts for the industry as a whole.

## F. Conclusions - The Potential for Change

### Current Trends

As the preceding sections have demonstrated, a number of key economic variables combine to produce a highly predictable structure in the Canadian film and video industry. The existence of economies of scale in the production and exhibition sectors combined with strong incentives to minimize risk and low barriers to entry into the distributor sector have resulted in a highly segmented industry structure. This segmented structure is characterized by a number of powerful vertically integrated firms who control the bulk of the revenues in the industry and a large number of smaller niche players with very little market power.

As a consequence of this dominance by a few firms, competition in the market has been reduced significantly, with the flow of product largely determined by exclusivity arrangements and leveraged acquisition based on a dominant position in either the U.S. market (the Majors) or the Canadian market (Pan-Canadian/Cineplex-Odeon). Current trends suggest that these practices are placing ever-increasing pressure on the independent distribution sector, reducing its access to theatrical product and substantially reducing opportunities to enter other potentially lucrative niches such as the home video market.

These trends, in turn, have been exacerbated by government policies which through the 100% capital cost allowance discouraged Canadian producers from seeking distributor participation in the production of theatrical properties and which, most recently, have contributed to the overall decline in the production of theatrical properties by focusing public funding on the television market.

Significantly, dominant players in the Canadian market are now capitalizing on the weak position of Canadian distributors to foreclose the new ancillary markets.

The potential for change in an industry arises as a result of industry corporate strategies or as a result of the combination of these strategies with a fundamental shift in technology. Both of these factors may be used to assess the potential for change in the Canadian film and video industry in relation to the trends noted above.

#### Change as a Result of Corporate Strategies

Based on the corporate strategies discussed in the preceding section, there is little evidence to suggest that current trends in the industry will be modified.

Given their ability both to produce properties and to use leverage to acquire independent properties for the Canadian and U.S. markets, it seems clear that, all other things being equal, the Majors will be successful in maintaining their position in the theatrical market. In addition, given the inter-relatedness of the emerging video market and the theatrical market, it also seems likely that the Majors and other more specialized U.S. video distribution companies will be able to establish firm control in the home video market. The Majors continue to face strong incentives to operate directly in the Canadian market and, at the same time, have little incentive to contribute to the development of Canadian theatrical properties or, except in limited instances, to cooperate with independent Canadian distributors.

Few barriers exist with respect to the corporate strategy of Pan-Canadian/Cineplex-Odeon. The ability of Pan-Canadian to use its vertically integrated relationship with exhibition to gain an increasing share of available independently produced properties is unchecked. As such, it is reasonable to assume that Cineplex-Odeon will continue with its corporate emphasis on exhibition and expansion into the U.S. market and that few incentives will arise to encourage it to invest in the production of Canadian theatrical properties.

Expansion into the area of pay television now effectively precludes Astral from directly participating in Canadian production. This apparently is consistent with its overall corporate strategy of consolidating the activities of the firm in the area of technical services, film and video distribution and exhibition. Nonetheless, Astral remains prepared to make financial guarantees to producers, perhaps as a way of reducing the business risk associated with its Canadian content quotas.

The suggestion that Famous Players may establish an integrated distribution firm also will complement existing industry trends, increasing the level of leveraged acquisition of independent product.

Almost alone among all players in the distribution and exhibition sectors, Canadian independent distributors face strong incentives to reverse current industry trends.

Given their difficulty in acquiring properties, independent distributors face strong incentives to create their own supply by investing in Canadian productions. However, the same market conditions which create these incentives also limit the revenues accruing to Canadian distributors and hence, limit their ability to invest. Current government policies reinforce this problem by

focusing public funding on the limited and limiting television market.

As such, it clear that those members of the Canadian film and video industry with the strongest incentives to modify current industry trends, also are the least able to do so.

#### Change as a Result of a Shift in Technology

A shift in the technology of any given industry often can result in major changes in that industry by modifying underlying economic relationships. Such modifications may include reduced barriers to entry, lowered cost functions or increased economies of scale. These modifications may, in turn, result in significant changes in the roles played by various segments of the industry.

In the Canadian film and video market, there can be little doubt that the rapid growth of the home video market is altering the way in which some consumers access properties. For example, the recent study commissioned by the Societe generale du cinema du Quebec attributes the demise of smaller marginal theatres in the province to the rapid development of this new video market. However, this has merely opened the door to further concentration of ownership in the exhibition sector and, in so doing, removed from the market those independent exhibitors who might have been

more open to doing business with independent distributors. As such, this effect of the video revolution has merely reinforced existing industry trends.

Beyond this, since the home video market is largely driven by a flow-through of properties from the theatrical market, existing dominant players in this market appear to have had little trouble extending their dominant positions into the new video market. As such, to the extent that new opportunities arise for Canadian firms as a result of the video revolution, they are likely to be primarily in the area of videocassette duplication -- as is illustrated by the corporate strategy of Astral.

Given this, it seems safe to conclude that the shift in technology that is occurring contains little potential for change in the underlying economic relationships which currently characterize the Canadian film and video industry.

## G. Policy Options

### Policy Objectives

Traditionally, Canadian film and video policy has been seen as serving both economic and cultural objectives. While it has been deemed important from an economic perspective to have a healthy film industry, it also has been seen as culturally important to ensure that Canadians have access to properties made by, and about Canadians.

The exact balance between economic and cultural objectives has, of course, been the subject of considerable debate, as has the nature of the properties which should be produced to serve these objectives. However, at the most fundamental level, there can be little doubt that Canada will not have a healthy film and video industry, in either an economic or cultural sense, if the industry lacks the means to produce Canadian properties, if it is confined to one small niche of the market or if it is effectively foreclosed from entering new and popular segments of the market such as home video.

As the foregoing analysis has demonstrated, it is exactly those conditions listed above which currently prevail in the Canadian film and video industry. The increasing market domination by a



limited number of vertically integrated foreign and Canadian firms with few incentives to invest in Canadian properties has the effect of denying revenues to those players who do have incentives to invest and to assist in the creation of an economically and culturally strong domestic industry.

Based on this, it may be concluded that effective policies in the area of Canadian film and video distribution will be those that are designed:

- i) to increase competition in the distribution marketplace;  
and in so doing
- ii) to increase the resources in the hands of those in the distribution sector who face strong market incentives to invest in the production of all types of Canadian properties.

## Policy Options

### a) Legislation to reduce the dominance of the Majors

Under this option, legislation would be introduced along with some form of regulatory framework to ensure that the Majors directly distribute in Canada only those films for which they hold world rights. This option, then, would directly attack the problems that are created by the tendency of the Majors to treat Canada as part of the domestic U.S. market.

A number of benefits may flow from this approach. First, Canadian distributors would have direct access in the Canadian market to a significantly increased number of foreign, independent properties. As was noted earlier, these properties increasingly are denied to Canadian distributors as a consequence of the Majors' diversified release strategies and the dominance of Pan-Canadian. These properties would not only increase revenues to Canadian distributors but also, could provide them with the product necessary to establish a position in the lucrative home video market. Increased revenues to Canadian distributors also could provide them with the resources necessary to make larger investments in Canadian properties.

However, even setting aside for the moment the international implications, there are a number of problems associated with this option.

First, the following table sets out the revenue flows that are likely to occur to Canadian distributors and producers as a consequence of a number of scenarios based on this option. The table is based on a model developed by the Department of Communications using 1982 data.

Scenario A represents the status quo in 1982, where Canadian distributors netted \$.98 and returned \$.39 to Canadian producers. Assuming that cost functions and the percentage of net returned to producers remain the same, Scenario B shows that if Canadian distributors had had access to all foreign independent products distributed in Canada their net would have increased to \$2.99 and their return to Canadian producers to \$1.19. While this would have produced a large percentage increase, the absolute level of payments to Canadian producers would have remained relatively small.

Scenarios C and D, on the other hand, which assume that the Majors derive either 10% or 20% of their revenues from Canadian films, show a much larger increase in the payments to Canadian producers. These scenarios assume that Canadian producers would be able to produce properties which are sufficiently attractive to audiences to draw that much revenue which, incidently, did not happen in the years of the 100% capital cost allowance.

Table XIV: Payments to Producers (\$ X 10<sup>6</sup>)

	<u>Canadian Distributors' Net</u>	<u>Payments to Canadian Producers</u>
<u>Scenario A:</u>		
Status	\$ .98	\$ .39
<u>Scenario B:</u>		
All independent properties to Canadian distributors	\$ 2.99	\$ 1.19
<u>Scenario C:</u>		
All independent properties to Canadian distributors: 10% of Majors' revenues derived from Canadian properties	\$ 2.99	\$ 4.65
<u>Scenario D:</u>		
20% of Majors' revenues derived from Canadian properties	\$ .98	\$ 8.39

While the assumptions on which this table is based are severely limited, the results do indicate that the financial impact of the type of legislative intervention proposed in this option could be relatively small when looked at from the perspective of increased investment in Canadian properties.

A second major problem with this option relates to the structure of the Canadian distribution sector itself. Given the dominant

position occupied in the market by Pan-Canadian, such legislation could merely result in the transfer of revenues from foreign distributors with no incentives to invest in production to a Canadian distributor with no incentives to invest. Such a repatriation of revenues would contribute little to overall public policy objectives.

Returning to the international implications of such legislation, it is clear that this option would provoke a major negative reaction both from the Majors and the U.S. government.

b) Measures to increase competition in the Canadian - owned distribution sector

As was set out earlier in this report, the increasingly dominant position occupied by Pan-Canadian in the distribution sector has the effect of substantially reducing competition in the marketplace.

Given its vertically integrated ability to make leveraged up-front guarantees, Pan-Canadian generally can outbid its Canadian competitors for available independent properties. As such, an increasingly larger portion of industry revenues is flowing to a Canadian distributor which faces few incentives to invest in

Canadian production. A return to greater competition in the Canadian marketplace could have the effect of returning revenues to those distributors with greater incentives to invest in Canadian properties and of allowing these players to penetrate all exhibition markets. Indeed, such competition and its impact on access to properties could positively modify the investment incentives which Pan-Canadian itself faces by encouraging it to seek an assured supply of properties through up-front investments.

This increase in competition in the distribution market might be affected through an action by the Director of Investigations and Research and the Restrictive Trade Practices Commission. A blanket prohibition of vertical integration between distribution and exhibition could be established or, as a less extreme option, requirements could be set in place to ensure that independent distributors continue to have access to the Cineplex-Odeon chain.

It should be noted, however, that it is beyond the researchers' competence to determine if such an action would be successful. As well, it must be remembered that such actions tend to move very slowly through the process. At this point, then, it is not at all clear that this approach alone would immediately or effectively achieve the public policy objectives.

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c) Measures which complement existing investment incentives

As was pointed out in option a), direct legislative intervention in the marketplace may have little ultimate financial impact on payments to producers. Under this option, it is proposed that the government directly focus its attention on increasing the financial impact of its action on payments to producers by working with the positive incentives that do exist in the industry.

For example, a program might be established whereby public funds are used to automatically match the contribution to a Canadian theatrical property committed to by a Canadian distributor. This would have a number of positive effects.

First, it would ensure that increased payments accrue to Canadian producers. Second, it would ensure that these payments are directed towards properties which are likely, as a consequence of the direct participation by a distributor, to be marketable and, therefore, to make a direct financial contribution to the industry and have a direct impact on Canadian audiences. Third, it would enhance the competitiveness of Canadian distributors by increasing their access to properties and by giving them the product necessary to penetrate a wider variety of exhibition markets;

including the lucrative home video market. Such penetration is necessary if the Canadian industry is to play a role in this rapidly evolving new market.

Of course, in a time of financial restraint, it may be difficult to find public funds for such a program. In this regard, a number of approaches are possible, including: (i) an increase in the withholding tax on foreign distributors; (ii) a new box-office tax; or (iii) a better allocation of Telefilm funds to reflect a new emphasis on theatrical as well as television.

Of these approaches, the first two are fraught with problems. An increase in the withholding tax for foreign distributors could be seen as blatantly discriminatory and could provoke a harsh reaction from the U.S. The implementation of a box-office tax would require the cooperation of the provinces, which could slow down the process, and would be strongly resisted by both exhibitors and the Majors, as was the case in 1977 when Secretary of State John Roberts proposed such a policy. As such, the path of least resistance might be a better allocation of existing Telefilm funds, particularly as this fund is projected to increase over time.



APPENDIX

The researchers benefitted from confidential interviews with:

- Dan Weinzweig
- Marty Bochner
- Peter Mortimer
- Andre Link
- Rene Mallo
- Millard Roth

In addition, interviews were requested from, but could not be arranged with:

- Garth Drabinsky
- Jack Bernstein