A NEW BUSINESS MODEL
FOR UK FILM PRODUCERS

APRIL 2010

Foreword

by John McVay, Chief Executive, Pact

We at Pact believe there is a unique opportunity to create a new strategy for the public funding of UK film production that could, at last, foster the kind of 'sustainable' film sector that has for so long been a goal of public policy.

The fundamental concept behind our proposals is that content creators would retain substantial ownership of intellectual property and have greater access to revenues from the films they create. This will lead to strong, entrepreneurial businesses than can attract outside finance and become the bedrock for the growth of the sector.

The adjustments we suggest are simple and cost-neutral. This is not about seeking more funds. It is concerned with using what is already on the table to create organic growth: growth that is based upon success rather than subsidy.

In our vision, the public entities which have been so supportive of the sector will continue their activities, but their objective will include empowerment of independent film companies rather than intervention on the sector's behalf. Responsibility and motivation for building a sustainable film ecology will be handled within film businesses instead of public agencies.

The public policy objectives for film will be more successfully met than is the case today. The cultural aims that underpin UK policy will continue to be fundamental to the sector's development. There will be more avenues for new and diverse voices. The UK is globally recognised as a source of new and established talent and we need a thriving sector that can secure that talent's future here in the UK.

It is vital that these changes happen now so that content creators are in a position to take advantage of the digital revolution, where disruptive technologies have changed consumer behaviour and are creating new ways of reaching audiences. This disintermediation will allow content creators to move up the value chain by having more direct relationships with their customers, but opportunities will be missed unless film businesses have the financial strength to serve as a platform for this expansion.

Our measures avoid the 'quick fix' philosophy that has been tried before to address sustainability using imposed rather than organic solutions. Sometimes it is better to have a 'good' idea than a 'big' idea, and Pact believes this report is filled with good ideas – that will work.

John McVay
London, April 2010

Report prepared by the creative industries consultancy Olsberg|SPI.

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Introduction to the report

This report has been commissioned as an independent report for Pact, by Olsberg|SPI and was developed through an extensive programme of research and consultation in the UK and international film industries. It proposes a completely new strategy for creating a healthier, more robust and successful UK film production sector, ready to take on the challenges and opportunities presented by the digital age. The new strategy will deliver true public value by consolidating the sector's position as a major driver of activity within the UK's creative economy.

Despite the best intentions of public policy to date the 'sustainability' of the sector, no matter how it is defined, remains an elusive goal. But it is a crucial goal and has been acknowledged as a cornerstone objective for public film policy for many years. In its earliest days the UK Film Council, in its 2001 paper 'Towards a Sustainable Film Industry',[1] wrote of its 'longer-term undertaking aimed at generating change within the industry at a structural level in order to create a truly durable business sector'.

The failure of the system is particularly true for production businesses that create intellectual property assets, often with the help of public money. These companies normally can neither retain the fair value of these assets, nor maximise revenue streams, because of the way the funding operates. This has sustained a dependency on project-based public funding that we wish to break.

The way to transform this is by creating a genuine partnership between public and private investment: a funding system that encourages organic growth of film businesses involved in production. This transformation would be founded on gradually increased profitability: the normal way in which successful companies are created in any business sector. Pact realises that forced solutions do not work and that only over time, as financial strength and performance is built, will companies become truly investment-ready and 'a truly durable business sector' emerge.

Under the new Pact proposals film companies will benefit financially from making successful films; they will be able to invest in their own films and, from a stronger financial base, also diversify their business models. Such diversification would include taking advantage of the paradigm shift that the digital age has brought about in the ways in which content is delivered to consumers.

The changes in mechanics are straightforward and focused on the overall, joint principles that:

- Recoupment of public investment in films should accrue 100% to the production businesses that created them, and
- The majority of the revenues so generated should be ring-fenced for exclusive future use, by those businesses, in the development and production of UK films.

Diagram 1 (see page 5) describes the gradual, organic development of the sector over time and a selection of the characteristics of that growth.

The remainder of this report outlines this proposal in more detail and offers comparisons, evidence and projections that support the new strategy. The information is presented as follows:

References

1. From the foreword by Alan Parker CBE, Chairman

Diagram 1: **Forecast growth of UK film sector**

YEAR 1

- Suggested policy levers enacted
- Producer in stronger negotiation position (gradually retaining IP)
- New voices continue to be supported by public sector investment

YEARS 2 - 3

- Broader range of quality UK films with funding increasingly sourced from the private sector
- Producers with ability to put own financing into their films
- Producers developing new business models and diversification strategies
- Increased private investment in companies with tangible assets and growth prospects
- Growth of producers creates benefits for UK talent
- Returns from successful films ring-fenced for future investment

YEARS 4 - 5

- Increased private investment drawn into sector for projects and companies
- Content creators exploiting IP in digital age
- Range of strong, diversified film businesses emerges
- Initial public sector funds constantly leveraged and re-cycled on-screen
- Talent development opportunities expand
- Entrepreneurial talent attracted to sector
- General benefits to wider UK sector increase
- Interests of public policy, private sector, content creators and consumers more closely aligned
- UK public enjoying range of higher quality films (longer development and more ambitious projects possible)
- Film strengthens its position as core participant in UK's creative industries
- Public policy objective of sustainable film sector beginning to be met

2

A new concept for developing world class UK film businesses

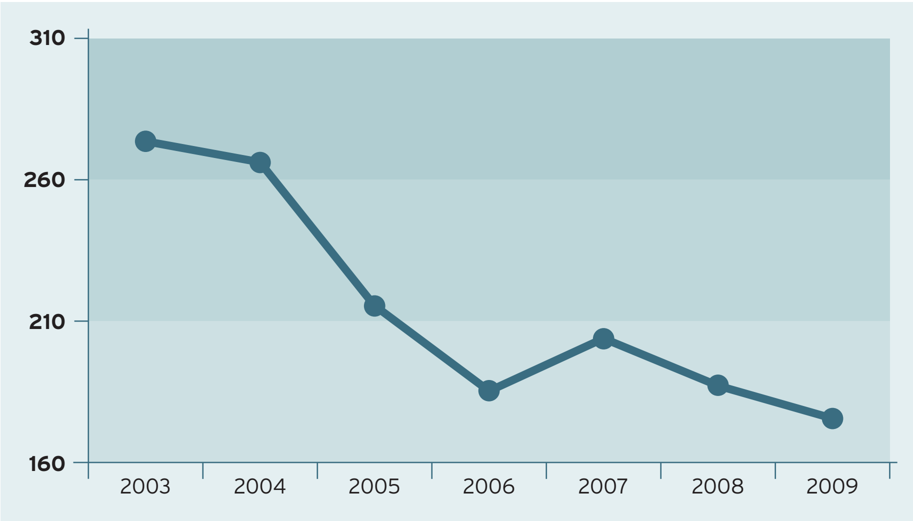
2.1
The vision

We recognise the important role that public[2] funding plays in the development and production of UK independent films; a role that has become increasingly important over the last 10 years as private sources of finance have fluctuated. The current level of public discretionary support for such films is estimated at close to £60m p.a.[3] When the UK tax credit is taken into account, we estimate total public investment exceeds £100m. Yet it is acknowledged that (for a variety of reasons) despite this support the ecology of the sector has not moved forward and, in general, UK independent production businesses remain weak, undercapitalised and over-reliant on funding support from these public entities.

While the total UK spend of domestic feature films has risen in recent years, the overall value of UK spend by UK independent feature films [i.e. non studio films and including co-productions] has fallen significantly. Diagram 2.1a (below) illustrates the decline in the UK production value of UK independent films over the last seven years, a period where the number of such films made each year has dropped from 139 to 88:

	UK spend on UK independent films (£m)[4]
2003	272.9
2004	265.5
2005	214.9
2006	184.2
2007	203.3
2008	186.3
2009	174.6

Diagram 2.1a: **UK spend on UK independent films (£m)**



References

2. Our definition of 'Public' entities includes the UK Film Council, the national and regional screen agencies, BBC Films and Film 4.
3. Excluding tax credit funding which is automatic (not discretionary) and based primarily on spend.
4. Source: UK Film Council: Film Production in the UK – Full Year 2009 Report

We believe the situation can be transformed, without calling for additional funding or indeed major changes in the way investment decisions are currently made. The objective of our proposals is to shift responsibility for the growth of the sector to those production businesses which do some or all of the following:

- Consistently make films that succeed with consumers;
- Understand how to attract private finance – both project and corporate;
- Take advantage of emerging opportunities in the area of digital distribution; and
- Demonstrate entrepreneurial capability to build diversified companies of scale.

The overriding principles behind our proposals are to:

- Ensure production businesses recycle the bulk of their revenues into the development and financing of future UK films;
- Optimise producer ownership of the intellectual property they create;
- Enable content creators who make successful films to have greater access to the revenues that result; and
- Enable the creation of stronger, and in many cases diversified, film businesses of scale.

The following diagrams describe how we estimate the measures proposed by Pact would alter the film funding landscape in the UK.

The measures recommended in this report will result in a greater number of successful film companies, with healthier financial results, which will be more attractive to corporate investors and lenders and thus have real opportunities to become 'investment-ready'.

Corporate and project finance from trade sources and financial institutions will become a better proposition if the basic UK producer business model is improved. There is evidence this would work, for we have seen the transformation of many UK independent television production businesses that resulted from changes to ownership rules and greater access to revenues.[5]

Financially stronger producers will have greater leverage in all their project negotiations and therefore in a position to further secure a greater share of revenues from their films. Companies that are more solid will also be better positioned to explore new business areas opened up by how digital innovations are changing the world of distribution.

All this can be achieved without major changes to the way that public entities currently operate, respecting, for example, their vital support for new and diverse filmmaking voices and talent.

Diagram 2.1b:
Breakdown of finance structure for typical UK independent film: year 1 (2009)

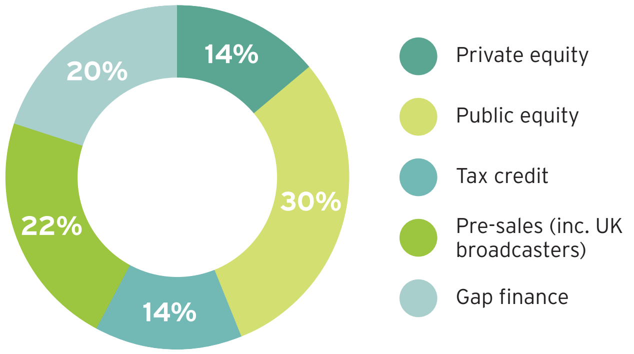
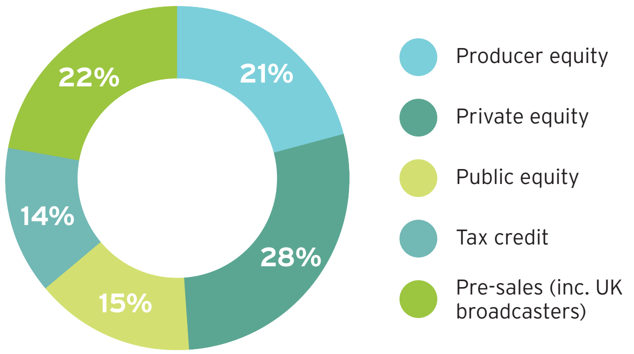


Diagram 2.1c:
Anticipated breakdown of finance structure for typical UK independent film: year 5 (2014)



References

5. Since the introduction of legislation leading to Terms of Trade between broadcasters and independent television producers, the independent television sector has doubled in annual turnover. Within this, companies of some global scale have emerged: the top seven independents according to turnover now generate revenues of more than £1.1 billion, twice as much as in 2003. Figures are from the Pact annual census and the Broadcast annual survey of the independent production sector. For further information email adam@pact.co.uk

2.2
The Pact proposals in summary

In order to achieve the vision described herein, we propose relatively simple adjustments of a few 'levers' of policy that will deliver an improved business model for production companies. Most of these deal with how recoupment is handled, combined with 'ring-fencing' the bulk of such recouped funds for specific use in the future development and financing of UK production.

In summary, there are several interlinked ways to achieve this:

- **'100%/recycled'**
  100% of the recoupment of public investment should accrue to the UK production company, with 70% of such recouped funds being ring-fenced and only available to invest in future development and production: the Film Depository Receipt ('FDR') system.
- **Film Depository Receipts**
  The FDR system acts as a 'lock box' whereby 70% of monies recouped are placed, on the production company's behalf, in an interest-bearing escrow account with a fiduciary agent such as the National Film Trustee Company. These accumulated funds may be accessed only by the production company and used only for the development and finance of future UK films being produced by that company.
  If such FDRs are not 'cashed in' within 5 years of their creation, then the funds revert to the public entity/entities which generated the initial investment, for further investment in development and production.
- **Tax credit as producer's equity**
  100% of the tax credit should be treated as producer's equity investment and this amount would therefore sit in the recoupment waterfall.
- **Terms of Trade with public service broadcasters**
  A new deal structure to incorporate the following terms for licences:
  - A reduction in the length of the licence period to 5 years; and
  - A new 'use it or lose it' provision under which rights would revert to the producer if the broadcaster was not utilising its broadcast rights.
- **Containment of legal and finance costs**
  In order to save costs and speed up decision-making the public entities should agree a pro-forma set of principal legal documents which would apply to all their films.
- **Higher tax credit for low budget films**
  We support the House of Lords Communication Committee's proposal for the tax relief level to be raised to 30% on UK films with a budget of less than £5 million.

Appendix 1 contains further details of all the Pact proposals.

2.3
Advantages for the public sector

Pact's proposals represent a major shift in the relationships within the film ecology, characterised by greater partnerships all around. The interests of the public sector, content creators, private investors and consumers will be much more closely aligned.

- The public agencies and producers will no longer be in opposition regarding Terms of Trade and share of revenues;
- Public investment will be leveraged to a much higher extent by production businesses that can raise more substantial investment from private sources;
- The development of the sector will be less reliant on, and less of a burden on, public finances which will liberate public investors in their investment choices;
- The quality, range, size and variety of films should all be enhanced – delivering the cultural and economic benefits that are sought by public policies, as well as films that UK (and overseas) audiences can enjoy;
- Innovation for the digital age will be carried on by stronger film businesses;
- UK filmmaking skills and creative talent would have a larger palette and greater opportunities;
- Reduced costs and less time needed for film finance transactions delivers greater efficiency for public and private investors; and
- The original public policy objective of a sustainable film sector would at last be met.

3

The talent and capabilities exist: now the system needs to change

3.1
Current obstacles to growth of UK film production businesses

The cultural and economic benefits that accrue to any country with a healthy film sector are now globally recognised. This has created a film environment in most countries characterised by meaningful support and funding from public sector sources. Generally speaking, only the major markets of Hollywood and Bollywood survive without public 'subsidy' and even the individual states of the USA have now introduced a plethora of funding schemes in order to build their production volumes.

Public policy objectives aimed at growing UK production levels usually are in pursuit of joint aims:

- To build a strong indigenous sector that delivers cultural and economic benefits to UK Plc; and
- To maximise the level of inward investment through attracting portable productions.

In recent years the UK has been particularly successful in the latter objective. Current inward investment volumes are at historic highs and the first quarter of 2010 is likely to see impressive levels of expenditure from overseas, particularly from US studios.

The UK has been less successful in building a strong independent production sector. This is despite the clear evidence that UK independent filmmaking skills and competences, both behind and in front of the camera, are second to none. It is important to recognise the role that the public sector entities have played in reaching this level of achievement.

A significant reason for this failure in creating a sustainable UK film industry is the typical financing structure that UK independent producers have to use in order to get their films made. This is characterised by a combination of:

- Complex, multi-party structures where producers find themselves without negotiating leverage because they are unable to provide their own funding;
- Investment terms from public bodies (for example the UK Film Council) that have prioritised their recoupment over producer earnings;[6]
- Difficult market conditions under which previous funding sources (pre-sales, gap finance) have become extremely limited;
- A limited ability to attract treaty co-production investment because of the tax credit rules and (in relation to Europe) not being a member of Eurimages;
- Complex legal documentation which is rarely finalised in time for the major cash requirements to be funded; and
- The high costs of finance in relation to fees, banking and legal costs that multiple third party financiers impose on the budget.[7]

Producers in the UK have adjusted over the years to these difficulties in part by attempting to keep budgets down in the face of increased costs of production.[8] But these efforts have been insufficient to alter or improve the basic business model.

These negative factors combine to create an environment whereby UK producers are far less rewarded when they make films that succeed with audiences, than they should be. UK producers are unable to secure substantial intellectual property rights. The risks involved in producing in the UK are not matched by commensurate returns from successful films. Accordingly, production businesses are unable to attract corporate investment from normal business sources and are condemned to remain financially weak.

References

6. This has been recognised by the proposed changes to recoupment set out in the UK Film Council: DICE consultation document.
7. We estimate such costs in the UK are at least twice the level found in countries such as France and Germany.
8. The average (median) budget of a UK independent film has dropped from £3.1m in 2003 to £1.9m in 2009 (Film Production in the UK – Full Year 2009 Report)

3.2
The competitive disadvantage faced by UK producers

The weak position of UK production businesses is particularly disturbing when compared to independent producers from other countries.

In the other large European film markets, such as France and Germany, the funding structures, and consequently the producer business models, deliver significant rewards to producers who make successful films due to relatively good Terms of Trade with public and private investors. This has resulted in many production companies reaching substantial size and financial strength.

This difference is demonstrated by the following summary which compares the financial results of the same hypothetical film with a €5 million budget and revenues available for financiers of €3.2 million. The results are shown from the producer's perspective assuming typical business models for domestic films in the UK, France and Germany. Details and assumptions used in this comparison are shown in Appendix A3.3.

Revenue shares (€ '000)	UK	France	Germany
Production company share of revenues from the film's sales	-	158	175
Production company own investment	-	500	500
'Profit' on investment	-	32%	35%

3.3
The financial weakness of UK producers

The weaknesses referred to above are evidenced in a report recently commissioned by the UK Film Council titled 'Analysis of the Corporate Finance of SMEs in the UK Film Industry'.[9] This report covered businesses along the value chain and its findings, particularly about independent producers, are revealing; they include:[10]

- In general, the frail state of balance sheets is a concern;
- Film businesses should do more to use their IP to secure corporate finance;
- There are few instances of private investment in film businesses and the 'equity gap' in the UK film industry is wide;
- Public sector investment in film businesses, as opposed to film projects, is minimal;
- Independent, stand-alone production companies are the least liquid and over half recorded retained losses at their last balance sheet date;
- Yet films produced by the independent sub-sector tend to be the most popular amongst cinema audiences.

Pact's reading of this analysis fits with its own experiences, and those of its members. UK independent producers consistently make films that work with audiences and critics alike, yet the current business model prevents them being able to benefit financially and therefore the growth of their businesses is substantially inhibited.

The proposals in this report would, over time and in an organic way, overcome these obstacles.

References

9. Completed in October 2009 by Northern Alliance Limited.
10. The following list is taken from the report.

4

Responsibility for sector growth

4.1
Empowerment

Despite the challenges of the UK independent producer business model, we believe it is possible to shift the balance of responsibility away from an over-reliance on public sector financing. The focal point of this strategy is to present realistic opportunities for entrepreneurial production companies to grow and to involve the (hitherto reluctant) wider private investment community. This has long been sought but will not be attainable until the basic business model of the producer stands up to scrutiny regarding the balance of risk and reward.

In order to achieve this shift, a public sector film business strategy is needed that supports the **empowerment** of production businesses rather than, as currently exists, one that focuses much more on the direct **intervention** of public agencies to provide the solution.

This report is not seeking more public money going into the sector. Far from it – the approach is to make much more of the funds that already exist and to use them to leverage additional finance from elsewhere, particularly trade investors and financial institutions.

We also suggest very little change in terms of how the sector currently makes its investment decisions. Rather, the production community is proposing a shift in the current Terms of Trade with public financiers to enable real, powerful and long-lasting structural change. There is substantial evidence that such adjustments can make a real difference to independent production businesses – witness the transformation in the UK's independent television sector.

We outlined in Section 2.2 (details in Appendix 1) a number of relatively simple adjustments or 'levers' to be used to make this shift away from public sector reliance to a new age of entrepreneurship, private investment and suitable reward for taking risk.

4.2
Taking advantage of the distribution paradigm shift

The quickening of digital innovation is increasing opportunities for content makers to take advantage of changes within the distribution ecology. This disintermediation means that the filmmaker is becoming ever closer to the audience. Throughout the sector, questions are now being asked about the precise role of intermediary elements active in connecting films and audiences.

Stronger companies with greater financial resources and retaining a larger share of rights will be better placed to take advantage of these changes and develop new ways of exploiting their intellectual property. Whilst this re-ordering within the industry is in progress, engagement and experimentation with changing business models will be key to future success and growth. Weak companies will be disadvantaged, whereas successful businesses with a sustainable operating model will be at the forefront of change.

4.3
Achieving growth

Various estimates of the level of UK independent production have put it at around £250m a year. This had been a remarkably consistent figure from 2004 to 2008. However the level of UK independent production dropped significantly in 2009 to £204m while at the same time inward investment productions reached record levels (£753m). Thus the overall capacity of UK film production is substantially higher than is accounted for by the current independent sector. The general opinion of participants is that the ceiling is far from having been reached.

Apart from the overall reduction in activity, the main change over this period has been the drop in official co-productions which in 2003 accounted for an unusually high 37% of the total spend but in 2009 was only 17%.

Pact believes its proposals will result in (UK independent) production levels returning to and exceeding the record levels of 7 years ago. The characteristics of this growth will include:

- It would be achieved gradually and organically, based on normal business principles that apply to every economic sector around the globe: namely profitable, sustainable and diversified film businesses with genuine growth potential that attract private project and corporate investment – currently almost completely absent from the UK independent production sector;
- Publicly-sourced discretionary funding would contribute a greater financial underpinning because 100% of the associated recoupment will be circulated within the private sector;
- Greater resources (time and money) would be available during the development phase, resulting in higher quality films;
- An increase in average budgets and greater quality on screen;
- An increase in the level of co-productions would result, whereby UK producers will have their own financial resources to contribute rather than relying almost completely on a tax credit that currently militates against such participations; and
- The production capacity for growth clearly exists, as the figures above show, with the possibility that a more healthy balance could be achieved between inward investment (always affected by the vagaries of the currency exchange markets) and independent production.

4.4
A wider range of films

Pact does not necessarily expect a greater number of UK films to be made, but certain characteristics would change.

With greater financial resources at their disposal, producers will commit more funds and time to development of projects. They would be in a much better position to resist the temptation to move into production before a project is fully ready in order to earn a fee, because downstream shares of revenues are unlikely under the prevailing model. Furthermore, since such fees often have to be deferred in order to secure outside risk funding, so the vicious circle of unhealthy business practices is maintained.

We also anticipate UK independent producers will have the ability to raise bigger budgets for their films. As companies build financial strength and are better able to attract outside finance, that limited sources of finance and over-reliance on public money will become less of a constraint. This greater ambition should lead to UK independent producers being able to produce (and own) larger budget British films hitherto mostly funded outside the UK. Examples of *Mamma Mia* and *The Constant Gardener* come to mind.

Producers with more substantial resources will continually seek new and diverse UK film voices – this has always been the foundation of our industry's profile. They will be better placed to house such emerging talents and to share the rewards with their fellow content creators.

5

Protecting cultural filmmaking/ developing new and diverse talent

Every thriving film sector depends on reinvigorating its talent base with a constant stream of new, diverse and innovative film voices. It will be important, therefore, to continue the work done by the public entities in discovering new and unproven voices and giving opportunities to filmmakers with diverse and sometimes challenging views. It would therefore be necessary to maintain an appropriate level of funding, across all the public sector film entities, for films from these filmmakers (e.g. the first and second time filmmakers which are the focus of the UK Film Council's new single production fund).

Additionally, the stronger and better-capitalised film businesses that would emerge will be better placed to house or 'umbrella' new talent.

A proposal that will assist is the suggestion, which Pact supports, recently made by the House of Lords Communication Committee for the UK tax relief level to be raised to 30% on films with a budget of less than £5 million.

Furthermore, UK film businesses will become stronger over time, and able to source private finance for their projects and companies. They will therefore become less reliant on sources of public funding for development and production support. This will leave more room for so-called 'cultural' filmmaking and Pact anticipates that a greater number of such films will be supported than at present. Additionally, stronger companies will be better placed to 'umbrella' new talent, being able to take more risks than smaller, stand-alone companies.

Public funders currently commit fresh annual discretionary funding considerably in excess of £50m. The Pact proposals leave the decisions as to which films to support completely in the hands of the public fund managers. Even though recoupment from such investment will be diverted into the control of the intellectual property creator, the annual funding remains available for the support of all films. Pact anticipates a gradual increase in the proportion of these fresh funds committed to 'cultural' filmmakers. As these films tend to have lower budgets this implies a larger number of such films will be supported than is currently the case.

Of course if the films are successful in the marketplace, the filmmakers are strengthened by having 100% of the recouped sums available for their future use.

6

The resulting scenario

The vision contained in this report is of a UK independent film production ecology that in, say, five years from now would have the characteristics described below. This would involve a lessening in the overall reliance on investment and other decisions from public agencies, but where those entities and the film community collaborate in driving growth and success.

For ease of analysis, these characteristics are clustered under the 3 elements of the UK Film Council's mission statement:[11]

6.1
Celebrating and safeguarding our film culture

- UK and global audiences have access to a broader range of high quality UK films in the cinema and across all platforms;
- UK films and filmmakers enjoy an increased level of global success in making films that work with the audiences for which they are intended;
- The UK film sector strengthens its position as a core participant in the UK's creative industries, illustrating the dynamism, creativity and opportunities that are typical in any world class creative economy; and
- Stronger, diversified film companies are better placed through digital distribution, to exploit their library rights, especially with improvements in high-speed broadband, thus providing audiences with greater choice in how they access films.

6.2
Assisting our film industry

- The production businesses that create content own a larger portion of their intellectual property and a greater share of the revenues that are generated by films that succeed with consumers, creating a better balance between risk and return;
- The UK film environment is populated with businesses of varying size and efficiency, but among them has emerged a group of strong, well-financed, entrepreneurial companies centred around more consistently successful production;
- These film businesses of scale are attractive to private investors, whether financial institutions or strategic trade partners, that provide funding for both film projects and corporate growth;
- These businesses also attract new potential partners and investors who are examining opportunities in film, from advertisers looking for brand association possibilities, to major retailers such as Tesco;
- The new, stronger film companies will also be attractive to entrepreneurs and executives from outside the sector who hitherto have resisted becoming involved in film because of the weak business model;
- The value of UK independent production has at least doubled;
- Production businesses of whatever size have the opportunity of being active at other points of the value chain, notably by having entered into digital distribution of their own films;
- A less complex finance structure for individual films, with producers providing a larger portion of the finance and fewer funding partners (and therefore lower transaction costs), that reduces the risk of films falling apart.

6.3
Nurturing our film talent

- The UK produces an even broader range and variety of films that showcase the skills, talent and achievements of our film community;
- Career and diverse job opportunities increase as the volume and quality of sustainable production grows;
- Producers would have revenues to share with the writers and directors who co-create the content, strengthening the links between the talent teams that are the foundation of UK independent filmmaking;
- The funding required from public agencies for commercially-driven films is increasingly met from the private sector, releasing more funding for emerging talent and first time filmmakers;
- Stronger and better-capitalised film companies will be better placed to house and develop new and diverse talent; and
- UK filmmakers enjoy greater success with international awards for themselves and their films.

References

11. Described in the UK Film Council's publication: *Digital innovation and creative excellence(November 2009)*

Appendix 1

The Pact proposals in detail

A1.1
'100%/recycled'

This is a fundamental element of our proposal and reflects a shift in thinking about the purpose of public sector investment in the development and production of UK films by UK producers. Up until now, the entities investing public money[12] have emphasised their need to recover, and keep, most if not all of the amounts that are recouped from their investments.

These recouped funds have not always been recycled into future similar investments. In fact up to now the UK Film Council, for example, has used the funds for a variety of purposes, including a funding contribution to the agency's overhead. After years of resisting the change, the UK Film Council has now suggested all its recouped funds are recycled into future investments, except for a 30% corridor which would go to the producer of the film. Several of the other public entities now recognise the principle of this producer corridor.

Our proposals take this new concept a step further, without any alteration to the creative decision-making process of public investments. They will, however, remove the need for the business affairs efforts of the public entities to be so focused on recoupment in order to meet internal targets. Judgements as to commercial potential will in future be much more the concern of the production companies, who will be optimally motivated to make successful films because the rewards, under our proposals, accrue, to a much greater extent than now, to them.

In order to create conditions for the growth of UK production businesses, and also break content creators' dependency on these entities, we propose that 100% of the sums recouped from such investment are channelled to the production company, not the 30% currently proposed. At the same time, the principle of recycling the funds into future production is maintained in our proposals, in that 70% of such funds would be secured for future investment in the development and production of UK films.

The mechanism for 'ring-fencing' these recouped funds is a new concept: a so-called 'lock box' created specifically for this new system – the Film Depository Receipt (FDR). This is a financial instrument described in detail below. The effect is to ensure that at least the same amount of funding as at present (i.e. 70%) is secured for future investment, while the investment decisions are the responsibility of the content creators. These recouped funds, evidenced by the FDR, may only be used by the holder (the UK production business) for future investment in the development and production of UK films. If the funds are not so used within five years, the FDR is terminated and the funds held in escrow are returned to the public body or bodies that originally invested in the films.

This approach reflects a shift in emphasis at the entities towards a much healthier empowerment of the sector, with stable and long-term growth as the aim, rather than direct intervention and control.

Please note that any enquiries concerning the sources of information for any of the data in these appendices should be directed to info@o-spi.com

References

12. From the UK Film Council, the national and regional screen agencies, BBC Films and Film 4.)

A1.2
The Film Depository Receipt system

The concept of depository receipts is to be found throughout the world of financial instruments and its proposed use here reflects the desire to apply increased professionalism and fiduciary responsibilities to the world of independent film finance. We have found that investors with no film experience are discouraged by opaque systems and complex transactions that increase their perceived risk in becoming involved. This of course is different to the inherent risk associated with independent film investment where (currently in the UK) the returns do not accrue to content creators in the way they do in other countries and industries.

Using the FDR system reflects a new and serious determination to improve not only the basic business model but also the mechanisms surrounding the making and exploiting of UK films.[13]

The FDR is a cornerstone of the proposals made in this report and it is designed to ensure that recouped funds from public investment remain available for future investment, by the FDR owner (the UK production company), in the development and production of UK films.

The use of FDR still leaves control over such resources in the hands of the producer rather than the public entity making the initial investment. This transfers responsibility from the public to the private sector while strengthening the UK producer's business model.

The FDR system could be administered by a collections agency such as the National Film Trustee Company which would already have the kind of administrative and communications systems in place to deal with the transactions. A new protocol would be established to regulate how the FDRs are created and safeguarded.

For example, the recouped funds would accrue in the FDR account at different times during any given year – so consideration should be given to fixing a maturity date 5 years from the year end in which the revenues are received. In order to safeguard against improper use of FDRs (in non-qualifying expenditures) a system would be created for drawdown consents.

A unique feature of the FDR is that it can be treated as an asset. It could be noted on the balance sheet of the owner company yet be protected from normal business creditors. The FDR would have a life span of 5 years commencing from the date it is issued. Its face value will be enhanced by interest accumulating on the deposit, less a small administration charge. The owner of an FDR will ultimately forfeit its right to the asset if it is not used within 5 years. In such cases, the accumulated cash will be passed over to the public investor(s) who funded the original production.

A1.3
Tax credit as producers' equity

When the new tax credit system was proposed in 2005 a major motivation was to attempt to improve the position of the UK producer in those films that garnered support from the public purse through this 'rebate' mechanism. This has not been universally achieved.

This motivation sat alongside another objective, which has been met to a much greater extent: to make the UK even more competitive when seeking to attract major international productions to locate, shoot and post-produce in the UK.

Turning back to the content creator's position, the effect of the tax credit has been primarily to reduce the risk of the investors by effectively reducing the cost of the film. Because of their weak business models, UK producers are generally unable to invest alongside third-party entities (including public agencies) and therefore do not gain in this way. By reducing the net cost, an obstacle to financing was reduced, but the producer's position in the structure remained weak.

In recent times, some established producers have been able to persuade public sector investors to allow the tax credit to be treated as genuine producer's equity. But this is by no means universal or even typical, and it rarely happens when private sector funding is part of the finance model.

Our proposal is to have enshrined in practice the principle that the tax credit is and must be treated as recoupable by the UK producer. This should apply to all films where the tax credit appears and where public funding is involved.

In business terms, when dealing with private investors, UK producers might still be pressured to share some of this new benefit. But under this new system the producer would be negotiating from a position of much more leverage. Indeed, the producer would accumulate more financial resources of its own over time. This financial strength would mean the producer would also be able to invest its own funds as a more equal partner in its films.

References

13. See Appendix 3

A1.4
Terms of Trade with public service broadcasters

BBC Films and Film 4 have been stalwart supporters of the UK independent film community and their expertise and funding has been crucial to the creation of films, and filmmaking talent, of global appeal. These films deliver a strong impression of the UK's life and lifestyles and the broadcasters are true cornerstones of public sector support for the UK film community.

Nevertheless, the terms on which they invest in productions can also have the effect of weakening the production company as regards their recoupment demands and approach to negotiating Terms of Trade.

Under our proposals, their situation regarding recoupment would change as their investments would in future be subject to the '100%/recycled' structure.

Furthermore, we propose a reduction in the length of the standard licence period to 5 years and a new 'use it or lose it' provision under which rights would revert to the producer if the broadcaster was not fully utilising its broadcast rights.

A1.5
Containment of legal and finance costs

Many UK independent films involve funding from one, or indeed several, of the UK public entities. In order to save on costs and speed decision-making these entities should agree a pro-forma set of principal legal documents which would apply to all their films.

There have been some attempts by leading film lawyers to establish a code of compliance for all public sector investors that would simplify and short-cut much of the complex and time-consuming work involved. These efforts did not secure support from the commercial lawyers whose fees might be reduced if the work load was also reduced, perhaps understandably. But public sector business affairs executives have worked together frequently over the years and are in a good position to insist on simplification and drive through changes.

The resultant reductions in costs would enhance the earnings position of all parties and a reduction in complexity might remove one of the obstacles to private sector investment in UK films: the risk associated with delays in completing legal paperwork and the rather opaque nature of transactions. This of course is in addition to potentially increasing efficiency in the delivery of public investment.

In fact a by-product of the changes in recoupment would be the greater alignment of interests of the producer and the public entity business affairs representatives. In fact the latter, with their vast experience of such deal-making, could provide an even greater service to the UK producer during the process of dealing with third parties.

A1.6
Higher rate of tax relief for low budget films

The tax credit rules already recognise the different treatment of films costing more and less than £20 million, providing a higher proportion of the UK budget for lower budget films. This acknowledges a desire to prioritise UK independent films, which tend to have lower budgets than most inward investment productions.

The House of Lords Communications Committee has proposed going a step further in accepting the need to address the difficulties faced by even lower budget films which do not have major market elements that enhance prospects for raising market driven funding, through pre-sales for example. These issues are exacerbated by the fact that UK producers face further difficulties in securing co-production finance, the availability of which has drastically reduced following the new tax credit rules.

The Committee proposes that the tax relief level be raised to 30% on UK films with a budget of less than £5 million and we support this suggestion. It will help to make available funding for many smaller films from filmmakers with new and diverse voices whose talent is essential for refreshing the UK's film ecology.

We anticipate that higher corporation tax yields from more profitable activity for the sector as a whole would compensate the public purse for any increase in public funding resulting from the higher level of tax relief. We understand a forthcoming report by Oxford Economics for the UK Film Council establishes that the proposed higher tax credit would be cost neutral to the Government.

Appendix 2

Public sector financial support measures for UK film

A2.1

Key public financiers and financial support measures 2007–8

The key public financiers of film production within the UK are as follows:

- UK Film Council, who manage UK Lottery distribution for film. As of April 2010 UK Film Council offers one single production fund, the Film Fund, whose annual value is £15m. In a break from the past recoupment returning to UK Film Council will be recycled into this fund.[14]
- The National and Regional Screen Agencies provide a variety of funds accessible to film production. National and Regional Screen Agencies are funded by both by UK Film Council and Regional Development Agencies. The larger production funds available to film such as the Screen Yorkshire Production Fund, East Midlands Media Investment Fund or the Screen East Content Investment Fund are funded via RDAs and funds are often European in origin e.g. ERDF.[15] Such European-based funds are diminishing throughout the UK
- The funds made available within specialised units of the public service broadcasters, namely BBC Films and Film 4.

All of these sources of finance are made available on a discretionary basis. In the UK in 2007–8 we have estimated that some £58.9m was available to independent production on a discretionary basis. A general breakdown of this figure is provided below:

- UK Film Council (£17m)
- National Screen Agencies (£12.5m)[16]
- Regional Screen Agencies (£7.4m)
- BBC Films (£12m)
- Film 4 (£10m)[17]

In addition we estimate that approximately £40m was accessed by independent production from the tax credit. In total our estimation of £98.9m was thought to be available for independent film in period 2007–8.

A2.2

Reduced funding environment

In line with reductions in public spending across the country, the UK film sector is looking towards a new period of austerity within public finances. This macro trend, combined with a directly reduced funding environment for UK Film Council as some degree of Lottery Funds are re-directed towards London 2012, and reductions in European funding from the regions, creates a reduced funding environment for film production. We modestly estimate this drop to be in the region of £89.9m per annum as of 2010.

Our strategy for enabling producers does not call for additional money to the sector but rather calls for the money which does exist to operate more efficiently. We believe that enacting the mechanisms outlined in section 3 will create simplification, drive down overall costs and create managerial efficiency and will be less demanding on the time of public agencies.

References

14. UK Film Council's stated objective in its recently published three year plan for the Film Fund 'is to operate a unified production and development fund Film Council which has four distinct points of entry for filmmakers, is focused on creative excellence and supporting filmmakers (producers, directors, writers) aspiring to make quality British films and, where the marketplace is unwilling or unable, to take some or all of the associated risk'
15. However, the figures cited above in 4.3.1 for the Nations and Regions do identify the level of funding made available to film from those funds.
16. This includes the Wales Creative IP Fund.
17. For broadcasters contextualise the £20m available with overall television spend.

Appendix 3

International comparison – public agencies and broadcaster financing

A3.1
Summary of international analysis

A3.1.1 Rationale for our analysis

In order to better understand and contextualise the position of the producer in the UK we conducted a survey of the production ecology for producers in four other countries as follows:

- France
- Germany
- Denmark
- Australia

Both France and Germany represent mature film economies in Europe comparable to the UK. Denmark represents a successful smaller European country with limited public resources but with a strong international film brand. Australia represents a country whose domestic brand is less well known abroad. However, Australia also represents a country which has, in recent times, done much to recalibrate its funding ecology for both domestic and international production.

A3.1.2 Some issues with comparisons

It is of course difficult to compare like with like when faced with a variety of schemes and funding situations. The French support system, for example, relies on the generation of finances from box office, ancillary sales and levies on the broadcasters, both public and private, across terrestrial and cable and satellite. Australia is a country which is unfettered by state aid concerns. Germany is highly regionalised administratively, meaning that a high proportion of all funding comes from the regions rather than from central administration.

A3.1.3 Key conclusions

Overall funding and availability of schemes

The table below summarises the overall estimation of public funding per capita and the availability of automatic and selective schemes.

Our survey of mechanisms and funds available show the UK to be a strong public funder of film. However, the UK does not operate, as all 3 European countries considered do, an automatic or semi-automatic support scheme which rewards the success (actual or perceived) of a film.

	UNITED KINGDOM	FRANCE	GERMANY	DENMARK	AUSTRALIA
Number of domestic films produced	86	196	128	34	34
Population (millions)	61.4	65	82.2	5.5	21.9
Estimated total public funding for film production (€ million)	€108.9 (includes broadcasters and estimation of tax credit)	€160.6 (includes proportion of broadcasters levy directed solely at film)	€170.95 (includes broadcasters)	€20.7 (includes broadcasters)	€41.8 (not including broadcaster contributions and tax offset)
Funding per capita (€)	1.77	2.47	2.08	3.76	1.91
Availability of automatic or semi-automatic funds which reward success?	No	Yes	Yes	Yes	No
Availability of automatic or semi-automatic funds which reward spend?	Yes	Yes	Yes	No	Yes
Availability of selective funding at national and regional level?	Yes	Yes	Yes	Yes	Yes

Availability of automatic support

The availability of automatic support in other countries is a key element in strengthening the position of the producer. The classic example of automatic support is the main French automatic funding scheme which is based on a combination of the degree of nationality of the film and box office takings.[18] With the French example, a producer is able to 'bank' funds and spend them on the production in hand or in the future. Another example is the semi-automatic 60/40 scheme operated in Denmark, via which the national agency is guaranteed to provide 40% of the funding if 60% of the funding is in place from other sources – demonstrating its commercial potential. Conversely the guaranteed availability of the remaining 40% allows the Danish producer to help generate interest from other sources, thereby improving their ability to raise finance from the start.

Other factors impacting on Terms of Trade

In countries where the producer's voice is stronger or where producers benefit from a strong trade body (such as France or Denmark) many other aspects of the Terms of Trade with public financiers have been negotiated to the benefit of the producer.

The table below summarises our key findings in relation to recoupment practises on discretionary investments for central national agency schemes as well as the retention of intellectual property. The summary below indicates that the UK producer is at a distinct disadvantage to his or her international counterparts.

In Germany and Denmark the producer will recoup a proportion of their original investments (20% and 50% respectively) before the public agency does so. In Australia recent regulation allows all recoupment to revert to the producer after a period of 7 years. With both the CNC in France and the DFI in Denmark, the agencies take no claim to intellectual property on funded films .

The cumulative impact of all these particular individual issues of the Terms of Trade is that the producer is positioned to be stronger longer-term in other countries, and is able to move from one project to the next if projects are successful with audiences.

These preferable Terms of Trade in other countries demonstrate an 'openness' and a degree of 'public-service' spiritedness on behalf of the public agency. Each of the country's regulations demonstrates the ethos and rationale underlying the public financing of film. In these and other European countries encouraging the availability of domestic product likely to appeal to audiences is favoured over the Terms of Trade imposed. Very often such concerns are driven by language and cultural protectionist concerns. However, regardless of impetus the outcome is typically a reasonably high share of domestic box office for national films, demonstrating that audiences are enjoying quality local films.

The example of Australia, which has been very forward thinking in its wide variety of investment forms (particularly to encourage company growth within the production sector) and recent new recoupment terms, provides a non-European example of where overall ethos and strategy are working towards strengthening the producer's position.

	FRANCE	GERMANY	DENMARK	AUSTRALIA
Discretionary funds – revenue recoupment terms	Producers have the right to offset repayment of their loans against investment in future projects at a rate of 25% (capped at €230,000). Instead of repaying the first 25% of their loans, producers have the right to invest this in their next project within two years	The interest free loan is 'conditionally repayable' with FFA recoupment only beginning after the producer has recouped 20% of original investment. Thereafter FFA recoups at a rate of 10% of revenue	The DFI recoups its funding after other investors (including the producer) have recouped 50% of their original investment. The same terms apply to funding given by the regional Film Fund	Recoupment reverts to producer 7 years after delivery
Intellectual property ownership	According to the CNC's 'investment agreement' the production company is recognised as the author of the film project and retains copyright	N/A	The DFI claims no intellectual property rights to funded projects	IP Rights revert to producer 7 years after delivery of film

References

18. The amount of funding that can be claimed is determined according to a 100-point scale setting the degree of nationality of a film: producers who have reached a certain number of points are granted a proportionate amount of funding for their next film.

A3.2
Details of international comparison

A3.2.1 Funding available from national and regional public agencies and broadcasters in the UK, France, Germany, Denmark and Australia in 2008

Below we provide full details of our country comparison.

- All currencies have been converted to Euros for ease of comparison.[19]
- It should be noted that the role of broadcasters – whether public service broadcasters (PSBs) or private channels – differs from country to country. In France and Germany, PSBs and private broadcasters, including cable and satellite channels, must contribute directly to national film production funds. A similar system operates in Denmark, where DR and TV2 Denmark provide a pot of production funding, and are obliged to support independent producers through distribution deals. In the UK, Film 4 and BBC Films provide production support autonomously, a system, which is replicated in Australia by ABC and SBS, which work closely with Screen Australia.[20]

	UNITED KINGDOM	FRANCE	GERMANY	DENMARK	AUSTRALIA
Number of domestic films produced	86	196	128	34	34
Population	61.4 million	65 million	82.2 million	5.5 million	21.9 million
Total public funding for film production	Estimated €108.9 million (includes broadcasters)	€160.6 million (includes proportion of broadcasters' levy directed solely at film)	€170.95 million (includes broadcasters)	€20.7 million (includes broadcasters)	€41.8 million (not including broadcaster contributions and tax offset)
Total regional funding available	Estimated €23.1 million (includes Nations)	€23 million	€72.23 million	€940,000	€14.5 million
Automatic and semi-automatic funding available (national and regional)	Estimated €46.3 million	€71.5 million	€60 million	€5.8 million	N/A
Selective funding available	Estimated €62.6 million	€76 million	Estimated €22 million	€9.6 million in 2008	N/A
Broadcaster contribution to production funding	€25.5 million	€39.8 million in 2008	N/A	€5.3 million	N/A

References

19. Please note that 2008 denotes the financial year ending April 2008 for UK and Australian figures unless otherwise stated. French, Danish and German figures are for the calendar year running from January 2008 to December 2008 unless otherwise stated. All Australian currency conversions are based on exchange rate on January 25, 2010: 1 EUR = 1.56293 AUD; the Danish Kroner currency conversion is based on the exchange rate on January 25, 2010: 1 EUR = 7.44505 DKK; the pound sterling conversions are based on the exchange rate on January 28, 2010: 1 EUR = 0.862621 GBP.
20. Further information can be found on individual agency websites.

A3.2.3 Principle schemes eligibility, recoupment, IP and definition of producer in the UK, France, Germany and Australia

Please note that funding schemes have been categorised as:

- Automatic (or semi-automatic) rewarding spend
- Automatic (or semi-automatic) rewarding success, and
- Selective/discretionary

	UNITED KINGDOM	FRANCE	GERMANY	DENMARK	AUSTRALIA
Automatic schemes that reward spend (national and regional)	HMRC 20-25% tax credit	• CDI 20% tax incentives • TRIP 20% tax rebate for inward productions	• Federal 20% tax incentive (FFA DFFF) • Hamburg scheme for employment of local freelancers on animation. • Bavarian Effect Scheme: whereby 1.5 times the offered production loan must be spent in Bavaria	See 60/40 scheme below	• Producer's 40% tax offset • Location 15% tax offset • PDV 15% tax offset
Conditions of spend-related automatic schemes	• UK films and qualifying co-productions are eligible subject to a point based cultural test • At least 25% of total budget must be UK qualifying spend • Up to 25% of qualifying budget for productions with budgets up to £20 million and up to 20% of budget for films with budgets of more than £20 million pounds • Qualifying spend is for products and services used and consumed in the UK: expenditure incurred by filmmaking activities (pre-production, production and post-production) that take place in the UK regardless of the nationality of people undertaking the activity	• CDI: 20% tax credit upon eligible French expenditure available to French films and French co-productions. In the case of co-productions, each production company must apply to the CNC separately. Projects must principally involve French and/or EU citizens • TRIP: 20% tax credit on French expenditure for inward productions capped at €4 million; minimum 5-days shoot in France	• FFA DFFF offers 20% tax incentive on approved German expenditure, capped at €4 million or 80% of total production costs. Feature films above 79 minutes running time and with budgets over €1 million are eligible. Minimum 25% of production spend must be German (20% for films with budgets exceeding €20 million) • Only available to Hamburg-based animation companies employing Hamburg freelancers • Bavarian Effect Scheme: 1.5 times the offered production loan must be spent in Bavaria	N/A	Subject to QAPE Threshold; Australian Content; Completion

Continues on page 23

	UNITED KINGDOM	FRANCE	GERMANY	DENMARK	AUSTRALIA
Automatic schemes that reward success (national and regional)	None	CNC Automatic support for feature films is a subsidy given to all French qualifying films (and co-productions), which fulfill the point-based criteria set out by the CNC. Levels of funding are determined by the number of French/EU elements (and therefore points) accrued by the project and by the box office, television and video sales that can be expected by the project. Funds can be spent on the project in question or other projects within two years of receipt of funds	• FFA Automatic Reference Scheme • Bavaria Achievement Loans (return payments on loans are reinvested in future projects) • Berlin Brandenburg 'Success Loans' • Bavarian Bank Fund: Upon recommendation from the Bavarian Film Fund loans of up to €1 million are made available to film projects which expect considerable commercial success	Through the 60/40, the DFI invests 40% of a film budget provided a film producer has already secured 60% of the budget and has potential for theatrical distribution	None
Eligibility criteria for automatic schemes that reward success	N/A	• Levels of funding are determined by a point system (out of 100) that evaluates creative and technical aspects of a project with a minimum qualifying French/EU component • Available to French productions and qualifying co-productions intended for commercial exploitation and theatrical/TV release • Language of production is not a limitation • Value of support given is determined by the value of box office and broadcast potential of the project	• FFA Automatic Reference Scheme: Only available to films commercially released in German cinemas with at least 30 prints (15 for productions with budgets under €20 million); applicants must have registered offices in Germany; running length must exceed 79 minutes (59 for children's films); producer must have invested minimum equity of 5% • Bavaria Achievement Loans: available to German producers and to certified co-producers; informal application process; producer must have invested minimum equity of 5% • Berlin Brandenburg 'Success Loans' are available to producers who have recouped their initial investments • Bavarian Bank Fund: Only available to projects already receiving funding from the Bavarian Film Fund	The 60/40 Scheme: targeted at films that could potentially sell at least 175,000 cinema tickets	N/A

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	UNITED KINGDOM	FRANCE	GERMANY	DENMARK	AUSTRALIA
Discretionary funds (national and regional)	• Film Fund (UK) • Three National Screen Agency Production Funds • Ten Regional Screen Agency Production Funds	• Support for Franco-German co-productions • Support for Franco-Canadian co-productions • Support for feature film musical scores • Support for foreign language films • Support for new technologies in production • Support for inward productions • Avance sur Recettes (before and after production) • Fonds Sud for productions with certain Asian, Middle-Eastern, African and Latin American countries • 11 regional production funds	• FFA Selective Funds are conditionally repayable loans of up to €250,000 (or exceptionally €1 million): The producer must invest at least 15% of the budget • Filmstiftung Nordrhein-Westfalen – Production loans of up to 50% (70% for low budget projects) • Berlin Brandenburg Medienbord production loans • Nordmedia Production Grants, up to 50% of budgets (exceptional cases 80%) • Mitteldeutsche Medienforderung Production Funding • Hessen Film Fund (HFF) combines the Lande Film Fund and the Rundfunk Film Fund which offer production funds of up to €75,000 per project to projects with strong territorial links with Hessen • Forderung Hamburg-Schleswig-Holstein (FFHSH): film production funding of up to 50% of a film's production budget (up to 80% for films with budgets under €800,000)	• Consultancy Scheme • New Danish Screen • Film Fyn • West Denmark Film Pot	• Screen Australia Feature Film Production Investment • Of 8 state screen agencies, only Screen West offers feature film production funding
Criteria of discretionary funds (national and regional)	Varies from fund to fund; Premiere Fund focusing on potential commercial and box office success; New Cinema Fund upon innovation and diversity	In order to be considered for selective funding, film projects must accrue French/EU points for creative and technical criteria as per the automatic schemes administered by the CNC 'Avance sur Recettes' is available to French and EU filmmakers. Funds are generally awarded at script stage, but can also be awarded after completion of the film. To be selected, a film should have secured theatrical distribution. Generally, the scheme targets first features and 'less commercial' projects which might not be made without state support	• FFA selective funding loans are disbursed for projects based on the understanding that the project will 'improve the quality and profitability of German Cinema' • Regional funding scheme qualifications strike a balance between commercial, artistic and territorial criteria with the greatest emphasis generally placed upon the latter considerations	• Consultancy Scheme: targets established filmmakers balancing commercial and artistic considerations in its funding decisions • New Danish Screen Scheme: targets cutting edge work, less commercial consideration • FilmFyn Production Fund: investments made with the aim of recoupment in mind	• Creative team • Script • Creative potential • Audience potential • Commercial potential • Project viability

Continues on page 25

	UNITED KINGDOM	FRANCE	GERMANY	DENMARK	AUSTRALIA
Discretionary funds – revenue recoupment terms	UK Film Council recoups at same rate as equity investors; Producer receives 5% of money recouped by UK Film Council from first dollar (this does not apply when the tax credit has been treated as producer's equity)	Producers have the right to offset repayment of their loans against investment in future projects at a rate of 25% (capped at €230,000). Instead of repaying the first 25% of their loans, producers have the right to invest this in their next project within two years	The interest free loan is 'conditionally repayable' with FFA recoupment only beginning after the producer has recouped 20% of original investment. Thereafter FFA recoups at a rate of 10% of revenues	The DFI recoups its funding after other investors (including the producer) have recouped 50% of their original investment. The same terms apply to funding given by the regional Film Funds	Recoupment reverts to producer 7 years after delivery
Intellectual property ownership	• UK Film Council takes a share of copyright ownership 'commensurate with its investment in relation to other equity investors' • Rights can revert to producer once UK Film Council's original investment has been recouped, however there is no consistent policy in place to govern this	According to the CNC's 'investment agreement' the production company is recognised as the author of the film project and retains copyright	N/A	The DFI claims no intellectual property Rights to funded projects	Intellectual property rights revert to producer 7 years after delivery of film
Definition of producer	The Film Production Company is defined as the company responsible for the principal photography and post production of the film and for the completion of the finished film. (There is no requirement for the film rights to be owned by the FPC at the time the film is completed)	The production company is defined as the company which initiates a project and takes financial, technical and artistic responsibility for its making. It is also the company which secures the completion bond for a motion picture	Film producers are defined as persons who are responsible for the production of a film right up to delivery of the final product – or share responsibility, as in the case of a co-production – and are actively involved in the production.	For the purposes of investment, the DFI specifies that the production company, co-producers and private investors recoup their investments. The DFI specifies that where investment from broadcasters is involved, they do not stand in the same recoupment position	No particular definition of the producer or production company is specified in Screen Australia's Terms of Trade

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A3.3
Comparing international revenue models

The following table compares returns from (modestly performing) identically budgeted domestic films funded under the different systems currently operating in the UK, France and Germany. Assumptions are set out further below.

Notes:

UK funding structure: *assumes investment from the UK Film Council and BBC Films. The producer has brought in equity investment from private sources.*

France funding structure: *assumes a typical French film whereby the production company brings funding from an automatic (non-refundable) scheme such as 'fonds soutiens' as well as its own equity investment, plus other support from national and regional funds.*

Germany funding structure: *as with France, assumes a typical German national film with a mix of automatic support, own investment, national and regional support.*

	UK	France	Germany
Typical funding structure (€ or £ in '000)			
Public fund discretionary equity – 'hard'	1,000	350	300
Public fund discretionary equity – 'soft'	-	150	500
Broadcaster equity – 'hard'	500	500	500
Producer own equity – 'hard'	n/a	500	500
Automatic public funding (recoupable, treated as producer equity) - 'hard'	-	400	400
Private investor equity – 'hard'	700	n/a	n/a
Tax credit/rebate	700	600	700
Domestic television licence fee	500	900	500
Territory pre-sales (included other domestic)	600	600	600
Gap finance	1,000	1,000	1,000
Total budget	5,000	5,000	5,000
Revenue shares (€ or £ in '000)			
Gross revenue	3,200	3,200	3,200
Less: gap finance	1,000	1,000	1,000
Available for equity recoupment	2,200	2,200	2,200
'Hard' equity	2,200	1,750	1,700
Available for all participants	-	450	500
Available for producer (assumes 25% of 'profits' for the UK production company, but 35% for France and Germany as these producers are also investors)	**-**	**158**	**175**
Producers 'own' equity investment		**500**	**500**
Profit on this investment (%)		**32**	**35**

Appendix 4

Regulatory issues

A4.1

State aid issues

A4.1.1 State aid and film

Legal basis for the public support of film production in Europe

Throughout Europe, and the wider world, governments make available funds for film production support. The wide availability of incentives throughout the world is witness to the desire of governments for film activity to take place, of the ambition to attract international productions and of the need to help support the creation of domestic product.

Within Europe it is primarily on the basis of the Cultural Derogation (EC Treaty, Article 87(3)(d)) that state subsidy is cleared for use.[21] Subsidy is made available in order to address recognised market failure within the sector. Through the Cultural Derogation and the principle of the Member State's right to self-determination, in cultural matters, each country is allowed to provide public finance to film. Current regulation around the interpretation of the Cultural Derogation for film will allow up to 50% of the budget to be provided from public sources. This is with the exception of difficult and low budget films, in which up to 80% of the budget can be publicly financed.

State aid definitions

There exists particular regulation governing the interpretation of the cultural derogation for film production.[22]

State aid is defined as an aid measure granted through state resources favouring the production of a certain good which may possess the potential to impact trade between Member States or to distort competition.[23]

Not all state aid is illegal. Where state aid is in line with established regulation guidelines, which indicate that this configuration of state aid is not contrary to the common interest of the European market, state aid is permissible and schemes can operate under the terms of those guidelines when notified and cleared by the EC.

Cinema aid guidelines

Current state aid guidelines for film production state that for projects which are not difficult and are low budget, up to 50% of the budget can be provided for by public resources. In essence if the state aid is compatible with regulation then this '50%' can be written off for state aid purposes.

This guidance for film production is given at a macro-level in terms of the way schemes operate. The European Commission's chosen way to examine the state aid issues behind schemes is to examine the mechanisms of the scheme in terms of existing top level criteria surrounding the cultural nature of the product, aid intensity, territorialisation issues and general legality criteria.[24] Thereafter productions benefiting from cleared schemes will be in accordance with state legislation.

References

21. The Cultural Derogation is not the only legal mechanism available for the clearance of aid. The Risk Capital Guidelines have allowed for the clearance of significant schemes in the UK, such as the East Midlands Media Investments and Screen East Content Investment Fund.

22. 'Communication from the Commission to the Council, the European Parliament, the Economic and Social Committee and the Committee of the Regions on Certain Legal Aspects Relating to Cinematographic and Other Audiovisual Works'. COM (2001) 534 Final.

23. In the Commission's definition of state aid, there are four key elements, which can be seen as tests for determining whether or not a measure is state aid. All four of the tests must be answered in the affirmative for the measure to be State aid:

- Is the aid measure granted by the state or through state resources?
- Does the aid measure favour certain undertakings or the production of certain goods (as opposed to general measures which affect all sectors)?
- Will the aid measure affect trade between Member States?
- Does the aid distort or have the potential to distort competition?

The Commission is typically very rigorous in determining the answer to the final two questions; therefore in practice, if a scheme meets the first two tests, it is likely to meet all four. State aid can be in the form of a grant or loan, but various measures, such as interest relief, tax exemptions, consultancy advice or the provision of goods and services on preferential terms, can also be viewed as state aid. Aid given to individuals or charities/not-for-profit companies can also qualify as state aid if there is competition (i.e. private companies) in the field.

24. In order to be cleared under the Cinema Guidelines, aid must abide by EC 'general legality' principles, so aid cannot:

- be reserved exclusively for nationals of one Member State;
- require EU beneficiaries to have the status of a national company; or
- require EU companies' workers to comply with national labour standards.

The Cinema Guidelines have four key criteria with regards to film support:

- Aid must be directed to a cultural product;
- The producer must be free to spend at least 20% of budget in other States (the Territoriality principle);
- Aid intensity is limited to 50%, though it may be higher for 'difficult and low budget' films (the definition of this category is up to the Member State); and
- Aid must not support specific filmmaking activities (e.g. post-production).

A4.1.2 State aid and Terms of Trade

Within those schemes cleared for top-level state aid issues there has been little or no questioning of Terms of Trade between the public financier and the production company.

The case of the French automatic aid scheme,[25] which was notified with the Commission in 2004 and cleared in 2006, gives a clear example of a permissible scheme which allows for the production business itself to enjoy very favourable Terms of Trade with public financiers without any State aid concerns.

Recoupment terms of UK Film Council are more commercial than other European national agency counterparts. UK Film Council's recoupment terms demonstrate the public sector's ability to operate commercially. However, we believe these terms are counterproductive to the UK in the longer term. Moreover we do not believe that these recoupment terms are required by current state aid guidelines for film production.

The particular area of where aid to a production (set up as a SPV) combines with generic aid to a business (must comply with de minimis funding rules) is a very grey area and one which has not been examined in any great depth and not one that has been called into question throughout Europe. That is not to discount, however, that in the future the Commission will become more interested in either this particular area or company development for SMEs in the film sector more generally. However, again the case of the French automatic scheme provides an example of a notified scheme which allows production businesses to 'bank' funds for future use and which overall grows the balance sheets of production companies.

A4.1.3 State aid conclusions

It is also worth pointing out that currently the main beneficiaries of a state subsidised product are those who exploit the product, i.e. the distributor and exhibitor. Due to lack of vertical integration in the independent sector, the commercial advantage of publicly funded product is passed downstream to those who exploit it rather than those who create it. This is a fact that has never really been questioned to date. Yet the producer, as the business entrepreneur of a film project who is tasked with managing the financial risk is often, incorrectly, perceived as the chief beneficiary of production funding.

To date, the actual Terms of Trade/recoupment terms between public support bodies or public service broadcasters and producers has not been the subject of much, if any, European Commission scrutiny Commercial advantages accrued by companies across Europe with regards to automatic funding have posed no significant problems to date.

Our suggested levers to be enacted by public policy will in some cases require a change of legislation. Some aspects of new legislation may well need to be negotiated with the Commission. In the current context of state aid interpretation for film and in comparison to precedent within Europe, we do not believe any state aid issues to be insurmountable.

A4.2
Lottery issues

In 2008–9, £1.38 billion was paid to the Department for Culture, Media & Sport from the Lottery for distribution to good causes.[26] These funds are currently distributed across the arts, sports and communities through 13 independent distribution bodies.[27] Those funds are distributed across the following recognised good cause areas:

- Arts
- Charitable Expenditure
- Health, Education and the Environment
- Heritage
- Millennium
- Sports

The film/screen industries are the only specific industries to have dedicated distributors in the form of UK Film Council and Scottish Screen. It is interesting to note that within this list of distributors, film/screen industries are the only sectors where the public sector requires of itself to operate on commercial terms. In general, within the wider cultural sector funding is given more directly as direct grants and subsidy.

References

25. Automatic support for feature-film producers is based on box office takings, TV screenings of films and video sales. The basis for the calculation of the sums that can be taken into account for exhibition is relatively complex. Roughly, a producer can expect 13 or 14% of the gross box office receipts. There is no minimum number of admissions required. The amount of funding that can be claimed is determined according to a 100-point scale setting the degree of nationality of a film: producers who have reached a certain number of points are granted a proportionate amount of funding for their next film. See 'Aide d'État NN 84/2004 et N 95/2004 – France Régimes d'aide au cinéma et à l'audiovisuel' for official clearance notification.
26. National Lottery Commission, Annual Report 2008-9, Page 9
27. The DCMS has responsibility within Government for National Lottery policy, and sets the policy and financial framework within which the distributing bodies for National Lottery grants operate. The 13 bodies are as follows: Arts Council England, Arts Council Wales, Arts Council Northern Ireland, Big Lottery Fund, Community Fund, Heritage Lottery Fund, Millenium Commission, New Opportunities Fund and Scottish Arts Council, Scottish Screen, Sport England, Sport Scotland, Sport Council for Northern Ireland, Sport Council for Wales, UK Film Council, UK Sport. Following the announcement that the 2012 Olympic and Paralympic Games will be hosted by London, an additional distribution body has been established – the Olympic Lottery Distributor.

Appendix 5

About Pact

Pact is the trade association that represents producers in independent television, feature film and digital media. Our membership creates, exports and invests in UK content, and generates annual revenues of £2.1 billion.

pact.

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