EFCA

EFCA'S COMMENTS ON THE COMMISSION's ACTION PLAN ON STATE AID
September 2005

Introduction – Executive summary

Last June 2005, the Commission made public its State Aid Action Plan. The Action Plan includes a set of guiding principles for a comprehensive reform of State aids, including as far as the film sector is concerned, the revision of the "2001 Guidelines" and the possible introduction of a block exemption.

The Commission has now launched a consultation process on the Action Plan. The European Film Companies Alliance (EFCA) welcomes the opportunity to submit its comments on the issue of State aids to the film sector. The present paper does not comment on the application of State aid rules to public service broadcasting.

The position of EFCA can be summarised as follows:

- The European film market is peculiar. It is essentially national because of language and structural reasons. The European film industry is a "cottage" industry, composed essentially of SMEs, competing for projects that may lead to production and targeting essentially a local language audience. Because of their structure and of weak financial abilities, European film companies are largely unable to benefit from the internal market. Difficult trading conditions are exacerbated by high entry costs into the distribution market which is dominated by an oligopoly of Hollywood majors. European film companies are dependent on State aids to exist - many years may pass before they meet a box office success.
  EFCA takes the view that the film sector should be challenged only and when the EC anti-trust authorities have been able to provide evidence of competition distortions. Whilst the European film industry in Europe is marginalised in the market place, such anti-trust scrutiny seems misplaced.

- The EC must ensure that, in conformity with its policy line adopted for the GATS negotiations, or in the framework of the talks on the UNESCO Convention on cultural diversity, Member States keep the freedom to establish *comprehensive* cultural policies to support a sustainable film industry.

- The distinction "low budget and difficult films" should be abandoned as it introduces an unnecessary and subjective element in the implementation of State aids for films.

- The aid intensity thresholds should take into account the diverse situations experienced in EU member States.

- Territorialisation requirements are important considering the overall structure of the film industry (and in particular the need to support the entire value chain and skills required). Territorialisation constitutes the main justification for Member States to develop comprehensive public policies for films. This issue should be addressed with flexibility by the Commission, and with consideration on the needs to secure a sustainable and indigenous film sector.

I. THE EUROPEAN FILM SECTOR AND THE INTERNAL MARKET

The completion of the internal market is expected to bring a harmonious development of economic activities and an increase in the consumers' well-being. This is achieved through, for example, enhancing opportunities for geographic specialisation, fostering growth and economies of scale, as well as through ensuring fair competition. Competition rules are implemented to accompany the completion of the internal market and to ensure its optimal functioning. State aids may constitute elements distorting competition and market efficiency.

Can these reasoning and tools be fully applied in the case of the film market though?

Firstly, the film sector can not be reduced to its economic dimension. Films provide universal and readily accessible medium for the expression and the representation of the different cultures and identities. The diversity of films on offer helps reflect, explore and challenge our histories, beliefs, and values, thereby contributing to mutual understanding. State intervention is required when the functioning of the market does not ensure the production, access to, and promotion of this diversity.

This situation has been acknowledged by the EC in other areas of European policies.
The 1999 mandate granted by EU Member States to the EC in the negotiation of GATS reads that the Union will ensure that the Community and its Member States *maintain the possibility to preserve and develop their capacity to define and implement their cultural and audio-visual policies for the purpose of preserving their cultural diversity.*
Furthermore the 25 Member States of the European Union aim to achieve the adoption of the UNESCO convention on cultural diversity which would *reaffirm the sovereign rights of States to maintain, adopt and implements policies and measures that they deem appropriate for the protection and promotion of the diversity of cultural expressions on their territory.*

Secondly, the implementation in the film sector of the traditional tools used for completing the internal market and for reaching maximum economic benefits (such as geographic specialisation or the implementation of EC competition rules), may result in counter-productive effects for European consumers and citizens, because of the specific features and characteristics of the film market and industry.

Structure of the European film markets

• It is difficult to conceive a single European market for films. The European film landscape is characterised by its **fragmentation** into linguistic and cultural areas. Language is a key issue as the circulation of films is made more difficult by the diverse languages in Europe. Sub-titling is also a barrier to the circulation of European films.
A film is essentially financed and made having a local audience in mind. It is very rare that non English language films make it at international level - they are the exception to confirm the rule. The most successful European films in 2004 (*Les choristes*) was distributed in 14 European territories but achieved 76 % of its box office in France - its country of origin.
The second most successful European film in 2004 (a German production *(T)Raumschiff Surprise- Periode 1)* made 88% of its box office in Germany and 11% in Austria. It was only distributed in German speaking territories.
European films hardly circulate and this is one of the justification of the MEDIA programme - an EC managed scheme that rewards distributors willing to take marketing risks on films from other European countries.

• The fragmented European film market is characterised by the presence of two categories of players: a few vertically integrated Hollywood majors and a myriad of specialised European companies.

Paradoxically, Hollywood majors are in a better position to take advantage of the European internal market: their productions are aimed at the international market, and these companies are vertically integrated to distribute and promote their films everywhere in Europe and beyond.

The European market is dominated by these vertically integrated global companies. They account for the bulk of market shares (around 80 %[1]). This market situation results in economic domination and in the marginalisation of European players.

Amongst the 20 most successful films in Europe in 2004 only two were European productions: *Les choristes* (n°16) and *(T)Raumschiff Surprise-Periode 1* (n°20). The lack of European distribution infrastructure penalises European productions which compete against films whose marketing budget is 10 times more important than their own production budget.

The US majors impose very high barriers to entry in the market and access to screens is more and more difficult because of the requirement to spend an extraordinary price for marketing and promotion. Largely as a result of these campaigns the market demands Hollywood films. European film companies cannot compete with the scale of Hollywood campaigns and production budgets. It is David against Goliath.

This weakness of European cinema is further illustrated by its weak international presence. The market share of European films in the US is less than 5 %. Trade deficit with the US is reaching abyssal figures (around 9 billion € according to 2002 figures[2]).

In order to understand the marginalisation of the European cinema it is necessary to get a more precise idea of the structure of the European film industries.

<u>The structure of the European film industry makes it unable to be competitive</u>

European companies are essentially SMEs, focusing on one or two films a year. They are extremely creative and able to work on shoestring budget. They do not own a catalogue of rights to weather the bad years. Their managers are driven by passion and count on generous local support to mitigate the consequences of market failures. The majority of them are in the "craft business" not in the "entertainment business".

To illustrate the market failure it is enough to address the lack of interest of the financial sector in the cinema industry in Europe. Private investors, banks and financial institutions are reluctant to invest in film projects or to lend to film producers:

- The activity is perceived as high risk - success is never predictable.
- European companies rarely develop slates of large budget films and therefore the risk attached to film production can not be spread over a series of productions (where the hits pay for the misses).
- The size of European national markets does not allow recouping investments in ambitious films, contrary to the North American market.
- The modest size of most of the European companies acts as a deterrent to investors.

Only Hollywood evolves at industrial level. A handful of European players have integrated strategies but they are all active in their local markets only - they have no European or international operations.

The integration of activities means that a single company is active along the whole value-chain, from development to post-production, distribution and promotion. Under this

[1] European audiovisual observatory, Focus 2004
[2] European Audiovisual Observatory, press releases 2003.

business model, filmmaking activities become distribution-led. There is an ongoing link between producers and distributors and aspects linked to the promotion, marketing and distribution of a film are taken into account right from the pre-production stage. Also, the critical size reached by integrated companies allows them to operate through the acquisition or the financing of "slates of films" as well as to be perceived as more reliable and solvable partners for banking and financial institutions.

Member States have recognised this essential weakness of the audiovisual industry. At the 2000 Lisbon summit, EU Member States mandated the European Commission and the European Investment Bank (EIB) to address the lack of investment in the sector. This lead to the I2I initiative with the EIB making available a lending capacity of € 500 million to the sector with a view "to enhance its competitiveness". A level of support that is more akin to industrial policy than cultural policy.

Because of these difficult market conditions and competitive pressures the **European film sector has become dependent on State support.**
This support takes the form of subsidies and regulations (for instance investment obligation on broadcasters or quotas) The latter forms of support are actually validated at Community level by secondary legislation: the Television Without Frontiers Directive, and this, since 1989.

The analysis of the European film markets and industry leads to the following conclusions:

• Because of cultural and linguistic reasons, the European film market is and will remain to a large extent national. Only vertically integrated structures benefit from the internal market.

• The lack of competitiveness of the European film sector is explained by the fragmentation of the market place and the collective dominance of the majors.

• These market constraints make the industry dependent on State support to survive not even compete.

• Independently of Art 87 of the Treaty, the European Union has recognised these market constraints in its policies:

- In the framework of GATS negotiations as well during the negotiations within UNESCO on an international Convention on cultural diversity, the EU has been promoting the principle of the need for Member States to be left free to set up comprehensive public policies to defend, develop and promote cultural diversity;

- The Television Without Frontiers Directive includes provisions (article 4 and 5) to support the broadcasting of European works and works made by independent producers, thereby acknowledging the need for public intervention to support diversity of offer in the audiovisual market;

- Policy initiatives jointly set up by the EIB and the Commission (as referred to above) were triggered by the acknowledgment of financial market inefficiencies and the need to bring a public policy response to market's failures.

- The MEDIA programme from the European Union is also a programme of industrial policy aimed at supporting the competitiveness of the audiovisual industry[3].

[3] cf. Council Decision 2000/821/EC of 20 December 2000 on the implementation of a programme to encourage the development, distribution and promotion of European audiovisual works (MEDIA plus - Development, Distribution and Promotion) (2001-2005)

EU policies show that Member States are allowed to be able to implement comprehensive cultural policies to support the sustainability of their local industry and local culture. EC competition policy needs to recognise this too.

As a result the EC internal market' principles and tools (such as geographic specialisation) as well as the EC competition rules (such as a strict application of State aids rules) must be carefully implemented to take into consideration this situation. A purely economic lecture is made difficult considering the marginalisation of European film companies in the international film market as well as the dependence on State aid for its survival.

II. THE COMMISSION'S POSITION ON STATE AIDS RULES TO THE FILM SECTOR

EFCA's concerns relate to:

- The overall EC approach to assess the compatibility of EC rules on State aids and film sector;
- The shortcomings of the 2001 Guidelines.

II.1. The overall EC approach to competition in the film sector- Article 87

The Commission in its 2001 Guidelines rightly points at the industrial character of cultural film production: *"the rationale behind these measures [i.e. support measures for the audiovisual production of films and TV programmes] is based on both cultural and industrial considerations"*.

And yet, under these same Guidelines, when it comes to explain the way it assesses the compatibility of national support schemes to EC rules, the Commission says: *"this aid is to be assessed under the culture derogation of article 87.3.d EC*[4] *rather than the industrial derogation*[5]*"*. The first of the four criteria laid down under the Guidelines is even clearer: *"the aid is directed to a cultural product. Each Member State must ensure that the content of the aided production is cultural according to verifiable national criteria"*.

In other words the only possible justification to green light a national support scheme according to the Commission must be cultural. The wording used under article 87.3.d ("promotion of culture") is interpreted in the strictest way, and support schemes aimed at promoting culture could not include the slightest measure of industrial policy.

EFCA believes this is misleading.

The stimulation of film making implies supporting the entire chain of production, from pre-production to the exploitation of films, from the most creative to the most technical elements (film facilities, such as facilities for production, location, shooting, music recording, and other post-production activities, domestic studios and visual effects). This includes measures that are not "purely" targeted at creative elements.

In the film sector, defining "cultural elements" as opposed to "commercial elements", and classifying "industrial policy" as opposed to an efficient cultural policy aimed to foster a sustainable film sector is misleading and counter productive. As rightly pointed out by the

[4] article 87.3.d provides for a cultural exemption according to which : *"aid to promote culture and heritage conservation where such aid does affect trading conditions and competition in the Community to an extent that is contrary to the common interest"* is compatible with the common market.

[5] this exemption is laid down under article 87.3.c. and provides that: *"aid to facilitate the development of certain economic activities or of certain economic areas, where such aid does affect trading conditions and competition in the Community to an extent that is contrary to the common interest"* is also compatible with the common market.

European film agencies (2001 EFAD Common Declaration on State Aid Rules) "*artistic and industrial aspects are inextricably linked*". The distinction between "commercial" and "cultural" is artificial and it endangers the sound development of a sustainable European film sector.

EFCA believes the priority of both EC and national actions in the film sector should be to foster its competitiveness and its sustainability through:

- Consolidating its economic viability and enabling better, stable and sustained investment in production,
- Reinforcing distribution channels,
- Developing promotion and marketing.

These objectives are both cultural and industrial.

EFCA calls on the Commission to take into consideration these two objectives when assessing the eligibility of national support schemes with the Treaty's exemption, and not using a limited interpretation of article 87.3.d.

II.2. The "2001 Guidelines"

The compatibility of State aids to film and TV programme production with the cultural exemption provided for in article 87.3.d of the Treaty are assessed by the Commission services on the basis of the Guidelines included under the 2001 Cinema Communication.

These guidelines include the following four criteria:

- The content of the aided production is cultural according to verifiable national criteria.
- The producer must be free to spend at least 20% of the film budget in other Member States without suffering any reduction in the aid provided for under the scheme.
- Aid intensity must in principle be limited to 50% of the production budget. Difficult and low budget films are excluded from this limit. It is up to Member States to establish a definition of difficult and low budget film according to national parameters.
- Aid supplements for specific filmmaking activities (such as post-production) are not allowed.

EFCA takes the opportunity of the present consultation to recall its reserves on the existing Guidelines, in particular on following points:

- The issue of aid intensity.
- The distinction between "low budget and difficult films" and other films.
- The issue of territorialisation.

✎ Aid Intensity

The 2001 Guidelines provide that: "*aid intensity must in principle be limited to 50% of the production budget with a view to stimulating normal commercial initiatives inherent in a market economy and avoiding a bidding contest between Member States. Difficult and low budget films are excluded from this limit. The Commission considers that under the subsidiarity principle, it is up to each Member State to establish a definition of difficult and low budget film according to national parameters*".

The 50% cap may be compatible with the French system (on the basis of which the Guidelines were initially negotiated), but it is not in relation to the majority of other European countries with smaller cinematographies. The majority of Member States require a higher level of support and in effect implement a higher level of support.

Under the 50% criteria, European successes such as *Rosetta* (winner of Palme d'Or in Cannes 1999) or *Dancer in the Dark* (winner of Palme d'Or in 2000) would not have been financed and therefore produced.

EFCA questions the value of setting up a harmonised threshold considering the variety of situation in the different countries.

↳ The distinction between "low budget and difficult films" and other films

Under the 2001 Guidelines, the Commission introduced the idea that some films deserve more aid than others. Those films are "small and difficult films".

This distinction does not exist in the Media programme which on the contrary is aimed to encourage success and commercial films with a view to addressing market imbalances.

The implementation of such criteria would mean that public policies whether local or European should discriminate in favour of certain categories of films, characterised as "low budget and difficult" films.

This could lead to create a discrimination against films that contribute to a sustainable film industry.

EFCA believes the distinction between "small budget and difficult films" and other films should be abolished.

↳ Territorialisation

The Commission is rightly concerned at the risk of fragmentation of the internal market as territorialisation measures hinder the provision of goods and services for audiovisual production. When such measures are implemented, producers benefiting from public support are deprived from the possibility of using services at lower costs in other countries. They must territorialise most of their spendings and, as a consequence, production costs may become higher, incentives for co-production are lower, and the circulation of non-national European films risks a further decline.

In theory, the suppression of territorialisation requirements will result across the EU in a better allocation of resources by the market. Jobs will be created in countries where production costs are lower. Producers established in countries providing for higher costs will have the possibility to produce more competitive films. In the long term, if we follow the European integration theories, this will create a win-win situation: more jobs, more "creativity", more competitive productions, and a reinforced "European industry".

This is why the Commission 2001 Guidelines introduce the principle that the producer must be free to spend at least 20% of the film budget in other Member States without suffering any reduction in the aid provided for under the scheme.

EFCA agrees that the objective of the EC on this issue should be to enable the freedom of producers to spend their production budget in other countries offering lower production costs.

But this should go in parallel to the aim to encourage the consolidation of sustainable indigenous local film industry.

Therefore EFCA believes the following objectives should be pursued:

- **The industrial film structures should not be undermined**

  The film industry tends to organise itself into industrial cluster and the stimulation of film making implies supporting the entire chain of production and exploitation of films from the most creative to the most technical. This aim is achieved through territorialisation requirements.
  Territorialisation measures help maintain a critical mass of infrastructure, and creative and technical expertise to facilitate the production of cultural films.

- **Encourage Member States to introduce comprehensive measures to support a sustainable film sector**

  Interestingly, in the US, the California Film Commission has just released a report conducted by the Los Angeles Economic Development Corporation which assesses taxes and jobs losses caused by runaway productions. In this report, runaway production to Canada and other foreign countries as well as some US states offering attractive tax incentives are cited as the main threat to local industry. In line with this report, Californian legislators are debating a bill that if approved will introduce further territorialisation requirements, namely a 12% tax credit on a production's California spend, up to a cap of USD 3 million.

  Territorialisation measures acts as incentives for Member States to set up comprehensive policies towards the film sector: the framework for Government support to the film industry reflects both the economic and cultural benefits these can bring to a country, including the creation of jobs, the attraction of inward investment, as well as indirect benefits that spill over from the film production to other industries and sectors, such as tourism.

  Public authorities only establish support schemes, as well as tax incentives or tax breaks, in so far as they benefit the local industry. They do not do so to subsidise the other countries' film sectors. Why should the Danish tax payers subsidise a French film?

  The suppression or the drastic reduction of territorialisation requirements may consequently result in a progressive destruction of the film sector in the few European countries where a film industry does exist, without ensuring the take-off of a domestic film sector in the other countries.

Territorialisation requirements are important considering the overall structure of the film industry (the need to support the entire value chain and skills required), as well as the necessary impetus for Member States to develop comprehensive public policies. This issue should be addressed with flexibility by the Commission. The results of the Study to be commissioned by the European Commission on this issue will be important to fully understand what is at stake.

About EFCA

The European Film Companies Alliance was founded in 1995. It is a truly pan-European association representing European film companies involved in production and distribution of feature films. The main challenges of EFCA are:

- To raise the profile of the European film community and explain its business operations;
- To keep its members informed on policy and market developments;
- To identify areas requiring joint actions;
- To obtain the establishment of EU support policies and programmes that address structural deficiencies, market fragmentation and the film industry's international competitiveness;
- To pull resources to pursue collective objectives.

EFCA aims at defending the principle of cultural diversity and at working for a competitive market place. Its ambition is to improve the commercial influence of the European film sector on the international market.

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