

# Chapter XXXV

## The Impact of the Internet on the Law and Economics of the United States Motion Picture Industry

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### **ABSTRACT**

*This chapter describes the far-reaching effects of broadband Internet access on the motion picture industry. It first provides a summary of the effects on the industry's business model: the Internet (particularly when combined with broadband connections) provides a new window for the movie studios to utilize in releasing their product. It next examines the ways that legal, political, and cultural environments are already influencing the industry's search for a new business model to replace the old. Finally, we draw on lessons from the music industry to predict how the industry will ultimately incorporate broadband technology into a new business model. The authors believe that the motion picture industry provides an excellent case study of broadband's effects on a mature industry.*

### **INTRODUCTION**

The United States motion picture industry, often referred to as Hollywood, is facing and will continue to face shocks to its existing business model and vertical relationships due to technological innovations in computer hardware and software

applications associated with the Internet. Two major developments have led to the entry of a new distribution technology: the online delivery of movies to consumers. First, personal computers have become increasingly powerful and the storage capacity on a hard disk has increased significantly. Second, consumers are increasingly

upgrading their Internet connections from dial-up to broadband and new consumers are initially adopting a broadband Internet connection. These developments create shocks to the existing ways of conducting business for the movie industry similar to the threats experienced by the music industry with the popularization of file sharing software supplied by Napster.

These shocks originate in both the internal and external environments of the industry. Internally, the industry must decide how to fit the release of video-on-demand films into its existing sequence of distribution channels, including theater release and video store release. The position of the Internet in the distribution sequence should be affected by factors similar to those that affected the placement of video rental and purchase in the distribution sequence 20 years ago. The external political, legal, and economic environments confronting Hollywood are causing the movie companies to adjust to issues such as piracy and file sharing facilitated by peer-to-peer networks as a result of the Internet, the lowering of reproduction costs of digital content, and the lowering of distribution costs of that content over the Internet. Related noteworthy characteristics of the Internet that have given rise to the challenges facing content providers in general are its end-to-end architecture and its openness, blurring jurisdictional boundaries. The resulting issues are analogous to what the music industry has experienced in its adjustment to the impact of the Internet on the music industry's business model.

The chapter is organized as follows. In the second section, the existing distribution channels for and revenue sources from motion pictures are described and factors that will influence the position of the Internet in that sequence are analyzed. Then, the legal, cultural, political, and economic environments are examined, including piracy and Internet file sharing and the various efforts that the industry has undertaken to confront these issues. The final section of the chapter will examine the lessons that the motion picture industry can learn from the music industry's experience with the Internet.

## **BACKGROUND: DISTRIBUTION CHANNELS**

During its lifespan, a motion picture is distributed through various channels, or "windows." In typical chronological order, these include theater release, DVD release (both rental and sales), home pay-per-view (PPV), pay cable television (such as Home Box Office [HBO] and Showtime), and finally standard cable and free broadcast television. Figure 1 summarizes the progression of a motion picture through various windows and indicates the new roles played by the Internet.

Windowing allows the motion picture industry to price discriminate. By price discriminating, the industry forces those consumers who are most eager to see a new movie and those who want the best experience (in terms of video and sound quality) to pay the highest price. This results in higher industry profits than releasing the movie into all windows simultaneously. In particular, the consumers that are most eager to see a movie with the highest possible quality pay the highest price (at a theater). Consumers willing to wait some number of months (and settle for a smaller screen and, typically, lower-quality sound) pay lower prices (DVD and home PPV). Ultimately the most patient consumers pay essentially nothing (broadcast/basic cable).

The first window, theaters, offers the highest quality experience in terms of video and sound quality. But, in part because it offers a superior experience (and an experience that is relatively expensive to provide), theater releases are priced the most expensively. North American sales of movie tickets totaled just under \$9 billion in 2005, down about 5% from 2004 (McBride, Grant, & Marr, 2006). Worldwide sales were approximately \$23 billion. The theater window accounts for less than a quarter of motion picture industry revenue (McBride et al., 2006). Decades ago, movie ticket sales accounted for the vast majority of motion picture industry revenue, but the opening of other windows has made ticket sales a less important window in terms of total revenue. By placing movies in the theater window, exclusively, for a number of months

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