2.1 Hollywood, Defined

Hollywood is a physical place, a district of the city of Los Angeles, California. It is not a city, as oftentimes erroneously referred to by audiences around the world, whereas West Hollywood is, representing one of the administrative peculiarities of the county of Los Angeles where it is located. Besides being a physical place, Hollywood is a metaphor for the American entertainment industry operating in Southern California, not unlike Wall Street, which is considered a proxy for the US financial sector. Unlike Wall Street though, where the New York Stock Exchange is still located, Hollywood as a physical location has lost over time prominence within the entertainment industry operating in Southern California.

There is still a particular geographic area known as the “studio zone” or Thirty Mile Zone (TMZ), with its center at the corner of La Cienega and Beverly boulevards in Los Angeles, where specific conditions for labor contracts in the entertainment business apply. Most of the “Hollywood productions,” however, take place outside this specific zone, taking advantage of economic incentives offered by locations around the world, generating the phenomenon of “runaway productions”: entertainment content financed and distributed by Hollywood studios, but physically produced somewhere else, oftentimes overseas. Of the original “Hollywood studios” of the first half of the twentieth century, only Paramount Pictures is still physically located in Hollywood at the turn of the twenty-first century. The other studios whether moved, as in the case of Warner Bros. to its current location in Burbank in the 1930s, or they were actually never there in the first place, but always scattered in the county of Los Angeles.

Over the decades however, the name has become synonymous with the American entertainment industry: an icon for audiences around the world on the one hand, and a point of reference for all the entertainment industries worldwide on the other. As Powdermaker put it, “Hollywood is a unique American phenomenon with a symbolism not limited to this country. It means many things to many people” (1950, p. 16).
It is a “state of mind” occurring wherever people connected with the movies operate (1950, p. 18), whose goal is the “mass production of dreams” (1950, p. 39).

For the purpose of this book, Hollywood is defined as the system of the US entertainment industry revolving around the following six major companies that are part of the Motion Picture Association of America (MPAA): Paramount Pictures, Sony Pictures Entertainment, Twentieth Century Fox Film Corporation, Walt Disney Studios Motion Pictures, Universal City Studios, and Warner Bros. Entertainment. All the studios, at the time of this writing, are units of large media conglomerates operating domestically and internationally in different segments of the entertainment industry.

The MPAA was formed back in 1922, as a trade association, as a result of the concerns posed by the threat of government censorship, and was exempt from antitrust law (Epstein 2005, p. 93). Its function is now to “serve as the voice and advocate of the American motion picture, home video and television industries,” domestically through the MPAA and internationally through Motion Picture Association (MPA) (MPAA 2008a).

It is useful to analyze the American entertainment industry located in Southern California as a system, whose center lies in the aforementioned Hollywood studios. A system can be defined as a “set of objects or entities that interrelate with one another to form a whole” (Hall and Fagan 1968). The distinctive characteristic of a system are: wholeness and interdependence, hierarchy, self-regulation and control, interchange with the environment, balance, change and adaptability, and equifinality (Littlejohn 2005). As a system, in addition to and dependent upon the six Hollywood studios, the following sets of entities also have to be factored in the analysis of the American entertainment industry as key elements: the talent agencies, the creative community (actors, directors, writers, independent producers, etc.) and their guilds, industry labor, the trade industry press, and specialized research firms.

Their interrelations centered on the Hollywood studios determine the outcome of the industry both creatively and economically. They indeed are interdependent and constitute a whole, and historically they have proven to be able to self-regulate (as in the rating system established by the MPAA for example) maintaining a balance, while changing and adapting to the evolving landscape, as they ultimately share the common goal of creating and sustaining the artifacts of the American entertainment industry. These interactions among different entities within the Hollywood system do not take place without conflict, as, for example, the recurring negotiations between guilds and studios on contracts renewals have consistently shown.

### 2.2 Hollywood’s Economic Leadership

The US entertainment industry, providing leisure time products and services for audiences around the globe, is the global leader in financing, producing, and distributing entertainment content (Amobi and Donald 2007a). According to data from the
US Department of Commerce’s Bureau of Economic Analysis, receipts for American film and television rentals abroad have increased steadily over the last 2 decades (see for example Koncz and Flatness (2007), p. 114), and in particular from US $2.5B in 1992 to more that US $13B in 2009 as shown in Fig. 2.1.

Entertainment represents one of the most relevant exports for the US economy, and a significant item of American trade in virtually every corner of the world. The major corporations in this sector are headquartered in Los Angeles County in Southern California, with field offices handling their operations overseas managing the distribution of their intellectual properties under copyright internationally, and stem from the original Hollywood studios of the 1920s. Hollywood can therefore be defined as a “global industry geographically concentrated” (Véron 1999, p. 9), with its entities physically located in Southern California with a truly global reach. The core business of the Hollywood studios is to finance, produce, and distribute entertainment content ranging from feature-length motion pictures to TV programs, including animation and live action series. The entertainment products they produce are experience goods (Shapiro and Varian 1999, p. 5), whose value is determined by the individual experience they provide to their audiences, an entertainment experience. These products are also public goods non-excludable in consumption, in that one person’s consumption of an entertainment product does not affect its potential fruition from another person, unlike other products as physical goods for example (Wildman 1995).

As a result, entertainment products usually are exploited through a carefully designed “shelf life” including theatrical release, home entertainment, Video on Demand (VOD) and Pay per View (PPV), Pay TV, Network TV, Cable TV, and ancillary markets domestically and internationally (Vogel 2004). The exclusivity and subsequence (in most cases) of each of these “windows” of exhibition allow
Hollywood studios to practice price discrimination of their products and capture a larger share of the value generated by their artifacts. These products fall also into the category of “information goods,” expensive to produce and cheap to reproduce (Shapiro and Varian 1999, p. 3), with the average “negative costs” (the costs to produce the first copy, or “negative” of the film) for a feature-length motion picture constantly exceeding US $63M in the period 2003–2007 (MPAA 2008b, p. 6). In addition to the negative costs, the marketing costs associated with the theatrical release alone of a movie have constantly exceeded US $34M in the same period. As a result, the total costs incurred by MPAA members to release domestically in movie theaters a feature-length motion picture in the period 2003–2007 have on average exceeded US $100M (MPAA 2008b, p. 6).

This “windowing model” developed in the industry is based on “contractually agreed-upon periods of time that permit the exhibition of films. Such release windows are based on revenue, and content moves from windows that draw higher revenue per viewer to those that draw lower revenue per viewer” (White 2003, p. 15). This release strategy in the distribution allows studios to capture larger and more diversified revenue streams (Blume 2004), as opposed to the risky business model utilized until the early 1950s, which included only revenues generated by theatrical exhibitions.

Over time, the relevance of the revenue streams originated by the first “run,” the theatrical exhibition, has diminished as the home entertainment and television exploitation of the properties under copyright have increased their importance. The television market in fact has access to the advertising revenue, estimated in the United States at US $74B by Standard & Poor in 2007 (Amobi and Donald 2007b, p. 3), and subscription revenue streams, estimated at US $75B by Standard & Poor in 2007 (Amobi and Donald 2007b, p. 15).

The sector could be defined as an oligopoly, with few (six at the present time) major players, all units of publicly traded media and entertainment conglomerates, accounting for the large majority of the product distributed in the United States and globally. The Hollywood studios, both domestically and internationally have a clear leadership at the box-office. Data from Box Office Mojo (http://www.boxofficemojo.com) report that over the period 2001–2006, the market share of the six Hollywood studios (considered within their conglomerates) averaged approximately 80% or more in the US theatrical market (Amobi and Donald 2007a, p. 7).

Also globally, the six Hollywood studios consistently rank at the top of worldwide charts in approximately the same period, as reported by Showbizdata (http://www.showbizdata.com). In particular, Warner Bros. ranked first with 16.2% of the global theatrical gross in 2007, Sony/Columbia Tristar in 2006 with 16.4%, Warner Bros. in 2005 and 2004 with 15.7 and 14.2%, respectively, and Buena Vista International (the distribution arm of the conglomerate Disney) in 2003 with 18.1%. In the same 5 year period, only once was there a non-US or non-Hollywood affiliated distributor among the top 10 positions in the share of global gross theatrical revenue (the Japanese Toho ranking tenth in 2006).

The international exploitation of entertainment products is an essential element in the development of Hollywood’s entertainment content, which is oftentimes produced
and distributed domestically at a deficit. Foreign revenue streams are instrumental in the recouping of the initial investment necessary to produce high value entertainment products, which are experience, non-excludable public goods, and in reaching a profit, whenever possible (Weinberg 2005). In addition, while the domestic market shows signs of having reached a stage of maturity, Hollywood studios continue to explore new ways to expand internationally in their quest to increase their revenue streams, as they are under constant pressure of delivering profit increases on a quarterly basis. International distribution constitutes a pivotal aspect in Hollywood studios’ business practices, as it represents a key set of “windows” of exhibition to capture larger and more diversified revenue streams from the same properties under copyright, stemming from studios’ libraries and current productions.

In general, the categories of foreign or international markets as a whole provide useful statistical data on the magnitude of the phenomenon, without however shedding light on specific real business practices. The general notion of foreign markets comprises vastly different specific local markets, and generally what is produced for the domestic US market is then distributed overseas, given the fractured nature and diversity of each market. The international distribution is handled by local field offices in the major markets. In so doing, studios are able to directly manage the release and distribution of their products (ranging from feature-length motion pictures to TV series, live action and animation, etc.) and their overall “shelf life” in the country they operate in. As a result, they can effectively practice cross promotions among divisions of the conglomerate and realize synergy among the various “windows” and revenue streams to capture the highest profit from their intellectual properties under copyright. A direct presence in relevant local markets, when allowed by local regulatory environments and economically viable for the relevance of the market, appears to be the preferred course of action for Hollywood studios, jointly or severally (Aft 2004).

Historically, the foreign markets’ distribution of movies has been following, logically and chronologically, the US distribution, with adaptations to local cultures and languages when necessary and economically viable. Oftentimes the timing of the releases in different markets has not been simultaneous to better capture the different economic potential provided by specific seasons in different territories: For example, the US summer blockbusters have usually not been released overseas until the more lucrative winter holidays season. In recent years however, the international distribution strategies of feature-length motion pictures appear to follow the trend of “day and date” release: Studios organize the simultaneous theatrical release in various markets globally to coordinate worldwide marketing efforts on the one hand and to discourage the diffusion of unauthorized content on the other (Aft 2004).

Entertainment content for TV, ranging from made-for-TV product to feature-length motion pictures, is handled through licensing agreements with local TV platforms (satellite, cable, broadcast or free TV, and increasingly with telecom and/or internet companies), establishing the number of runs per period, its exclusivity (or lack thereof) in the territory, usually within “package” deals including different products, which can be current ones and/or stemming from the studios’ libraries. Havens (2006) identifies three distinct phases in the development of the global television
marketplace in the last 5 decades. The first wave, from 1957 to 1972, is considered a “formative moment” of the landscape (2006, p. 17), when most of the business practices of the marketplace were generated, with US content clearly leading the international flow of entertainment content. The second phase, from 1973 to 1985 showed signs of contraction of the global market for US producers, as local productions capacities increased (2006, p. 24). The third phase, from 1985 to present, has been witnessing a second wave of television globalization fostered by the rise of new platforms, made available globally by new communication technologies, mainly cable and satellite (2006, p. 27).

Hollywood studios are interested in increasing their presence in relevant territories to capture a larger share of local entertainment consumption in various markets, both in the movie and the TV segments. As a result, they have started to engage in coproduction in foreign languages and with foreign entities: The end products adapt on the one hand to local cultures while on the other they rely on the existing global structures of distribution of entertainment content. This strategy of localization of entertainment (Chalaby 2006) appears to be effective to increase even more their presence in relevant foreign markets within local regulatory environments, while at the same time leveraging existing corporate structures and content under intellectual property rights.

### 2.3 Economic Analysis of the Hollywood System

The Hollywood system comprises profit-oriented entities operating jointly and severally to reach a profit in the creation, production, and distribution of entertainment, domestically and internationally. It represents a relevant industry in economic terms, and specifically for the United States, a key export within its international trade balance. As such, it is useful to analyze it within theoretical frameworks drawn from the field of economics. In particular, the branch of industrial economics provides useful tools to analyze the entertainment sector and the cluster of the Hollywood studios within the sector, their competitive advantages and strategies, and the evolution of their strategies over time.

To specifically analyze the structure of an industry, Porter proposes the “five forces of competition” theoretical framework (1980). Applying the framework to the American entertainment industry, they are: the competition and rivalry among the existing firms within the industry (the Hollywood studios), the bargaining power of the suppliers (the content creators), the bargaining power of the buyers (the media packagers), the threats posed by new entrants, and threats posed by potential substitutes, as illustrated in Fig. 2.2.

Their analysis provides a useful starting point for subsequent evaluations on the nature of the industry. The magnitude and the interaction among these five forces determine the structure or the sector, its boundaries and dynamic evolutions, its players and their collaborative and competitive interactions, the existence of barriers to entry the sectors for newcomers, the degree of existing competition in the industry, as well as its attractiveness and its equilibrium overtime.
2.3 Economic Analysis of the Hollywood System

Utilizing this framework, the structure of the US entertainment industry is best described as a cluster of competitive industries: an oligopoly of six entities, the Hollywood studios, or “sexopoly,” as Epstein puts it (2005, p. 93), which solidly share the leadership in the competitive landscape. While intensely competing on certain aspects of the business, as access to talent, Hollywood studios cooperate in others, as in the activities supported by the MPAA, ranging from the rating system for the feature-length motion pictures released in theaters to the defense of the intellectual property rights of entertainment content against its unauthorized utilization.

Their competition appears to be rarely based on cost advantage, resulting in the production of entertainment at the lowest possible cost, rather on differentiation advantage, producing the best possible entertainment content and recouping the investment on a global scale. As mentioned, they are also associated in the MPAA, domestically and internationally, to protect their interests. The competition among Hollywood studios appears to stimulate the production of entertainment artifacts in line with the demand of audiences worldwide: Their products have indeed the leadership in the US entertainment business and globally.

In the process of creating and distributing entertainment content to different audiences, Hollywood studios have historically altered their strategic positioning, successfully adapting to the changing economic and political environment. Originally positioned as exhibitors at the beginning of the twentieth century, the founders of Hollywood studios strategically decided to enter the production side of the business to secure access to content (Gabler 1988). These entities also decided to move from the East coast to the West coast of the United States and to Hollywood in particular for two distinct sets of reasons. On the one hand, the mild, sunny climate and the diverse landscape lent itself to outdoor production throughout the year. On the other hand, setting their operations in Southern California helped the independent
studios to effectively circumvent existing patents and the actions from patent holders operating from the East Coast (Lessig 2004, pp. 53–54).

In 1915, US courts deemed the Motion Picture Patents Company (formed by the holders of the patents involved in the production and distribution of entertainment via movies, constituted mainly around the patents owned by the Edison company) an unacceptable monopoly and ordered it to be dissolved. This decision proved essential for the development of the then independent production studios, which eventually morphed into the Hollywood studios. A completely new and more diversified industry emerged as a result of this specific government intervention, and the independent studios generated what is usually referred to as the “golden age of Hollywood.”

In the “golden age of Hollywood,” approximately from the 1920s to the 1940s (Jewell 2007), the studios coped with high levels of uncertainty and risk associated with the volatile demand and the difficulties intrinsic in the production of entertainment. They did so by completely controlling all the different aspects of the production of entertainment in their studio “back lots” with exclusive contracts with talent. Furthermore, they became fully vertically integrated entities, as producers, distributors, and exhibitors of filmed entertainment.

As early as 1921, however, business practices in the distribution of motion pictures combined with vertical integration with exhibitors determined a US Federal Trade Commission (FTC) complaint against Famous Players-Lasky Corporation regarding the practice of block booking (the bundling of films as a distribution strategy of the studios towards the independent exhibitors). The complaint originated a series of subsequent rulings and consent decrees and their enforcement eventually led to the Paramount consent decree in 1948, when Hollywood studios, then mostly vertically integrated, were obliged to divest their interests in the exhibition side of the business (their movie theaters operations).

As a result, the industry became more competitive, not only in the exhibition segment increasing the number of independent theatrical exhibitors, but also in the production segment of the business (Burgelman and Meza 2003). Hollywood studios ceased to be organized as a dream factory, as they could not practice exclusive contracts any longer with exhibitors on the one hand and with talent on the other. Talent agencies’ relevance also increased significantly as a result and the competitive and operative landscape of the industry was modified ever since.

In 1970 the Federal Communications Commission (FCC) adopted the “Financial Interest and Syndication rules” (FinSyn rules), prohibiting TV networks from owning a financial interest in the production or syndication of many shows that they aired, specifically during prime time (Burgelman and Meza 2003, p. 9). As a result, independent content creators flourished, so did independent TV stations. The result was more voices participating in the media arena across the country, both in the production and the distribution of entertainment.

On the other hand, the Telecommunications Act of 1996 deregulated some of the restrictions operating in the media ownership and cross ownership among media outlets and allowed the FinSyn provisions to expire. Following the deregulation of the communications industry by the Telecommunication Act of 1996, the landscape
has been witnessing an acceleration of concentration in the media and entertainment industry across its different segments, leading to what has been defined “merger madness” (Litman and Hoag 1998), and the trend still continues.

As a result of the changes in the landscape, and the reactions of Hollywood studios to gain and maintain their leadership in the US entertainment sector, these entities now focus on the distribution aspect of the business. They are, as an industry executive eloquently puts it, “basically distributors, banks, and owners of intellectual copyright” (Epstein 2005, p. 106). Their strategic role and overall positioning has clearly shifted from the golden age of the Hollywood system. While then most of the studios controlled all the different aspects of the business, from production to exhibition, in order to minimize the risks associated with their activities, they now utilize strategic leadership in the key aspect of the distribution of entertainment content, domestically and globally.

Therefore, in the US entertainment business value chain, determining how value is created and delivered in the entertainment business, Hollywood studios are mainly positioned between the content creators and the packagers of entertainment, the media outlets, as shown in Fig. 2.3, explaining how value is generated in the US entertainment business and who the different players are, with their activities.

In the twenty-first century’s Hollywood system, the studios focus on the financing and distribution of entertainment including the marketing and promotion activities. Their strategic positioning and key success factors appear to lie in their ownership of copyrighted entertainment in their libraries and their know-how to generate value through their exploitation in aforementioned “windows.” Also relevant is their access to finance on the one hand and packagers/media on the other, as they are part of large vertically integrated media conglomerates, and their established, longstanding relationships with talent and talent agencies.
Another key element in Porter’s cluster analysis is represented by the potential threats from new entities attempting to enter the landscape and challenge Hollywood studios’ leadership. Historically, the threats posed by potential new entrants have been, in the last decades, low due to the existing barriers to entry for new comers determined by existing know-how and the capital intensive nature of the business, both in the filmed entertainment and TV content. Usually, new comers do not have the know-how to operate at a profit in this particular industry, nor can they rely on an established professional network, which calls for decades of working relations with the supporting and related industries, as talent agencies for example, even should they have access to the necessary financial resources.

The economic barriers are specifically relevant: Currently the average cost per motion picture theatrical exceeds $100M, including “negative costs” and distribution costs (MPAA 2008b, p. 6). As mentioned earlier, movies rarely recoup its initial investment in the theatrical run; rather when they indeed do it is only after the exploitation of the property under copyright in the different windows of exhibition available. This is generally true also for TV content, usually produced at a deficit for its first TV run, which reaches break even and eventually profit only when it reaches a critical mass of episodes to be exploited in subsequent windows (as in syndication TV for example).

Therefore, the inherently risky nature of producing and distributing entertainment in the US market can be best managed by diversifying the offer, and spreading the risk, among different films and TV series per year, and implementing the access to worldwide network for the distribution of their products along their value chain, through the different existing media, TV networks, broadcasters and pay TV services, cable channels, and syndicated stations. Virtually, all the Hollywood studios are part of publicly traded media conglomerates, which own diversified media assets in the United States, the only exception being Sony Picture Entertainment (foreign owned, and not allowed to own significant equity positions in the US broadcasting industry).

The analysis of the US entertainment industry brings to the fore the intrinsic issues the industry faces in order to create and capture value from experience goods in a volatile and risky business through different “windows” of exhibition and licensing, leading to diversified revenue streams (Blume 2004). Hence, the necessity arises not to focus solely on the theatrical markets, but to analyze the entertainment industry as a whole, comprising TV and advertising, in a landscape where the ICT revolution is looming as the sword of Damocles for the Studios, their business models, and global leadership.

The negotiation power of the distribution channels, ranging from movie theaters exhibitors to TV outlets is not particularly threatening for Hollywood studios, which own the entertainment content on the one hand and are part of media conglomerates on the other. Similarly, the suppliers, who contribute to create the content, do not have high bargaining power as an economic dimension (although it is worth noticing that “A list” top talent and their representatives have clear negotiation clout in specific deals). Therefore, the existing threats from suppliers (content creators) and buyers (media outlets) in the US media and entertainment landscape or substitutes of entertainment have been relatively low so far, leading through a virtuous circle to the existing prevalence of Hollywood in global entertainment.
However, at the turn of the twenty-first century, as Hollywood studios are facing the challenges of stagnant revenue streams in the US domestic market, with the “DVD market showing signs of saturation,” they are bound to explore “alternative means of content exploitation” (Amobi and Donald 2007a, p. 1), as they are expected to deliver profit increases on a quarterly basis, and to devise new business models based on the technologically evolving competitive landscape. It becomes necessary then to specifically identify the existing drivers of Hollywood’s competitive advantage and analyze them in more detail.

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