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China's IPR Protections and the U.S. Entertainment Industry

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Good morning Mr. Chairman and Commissioners,

I'm honored to be here today on behalf of Warner Bros. Entertainment Inc., a filmed entertainment creator and distributor and owners of one of the largest commercial theatrical and television libraries in the world.

The Commission's hearings over the last two days regarding China, its high tech development as well as its government's views towards IPR and foreign market access are important issues that must be understood and addressed if our industry, the filmed entertainment industry, can hope to build viable businesses and partnerships in China.

While all Hollywood Studios are experiencing the same level of frustration and disappointment in our efforts to enter the China Market, given Warner Bros. long history in the region, we hope to share some firsthand experiences with you today. Warner Bros. was the first Studio to establish distribution arrangements in China. We opened our first office in Shanghai in the twenties and since the Mainland was reopened to foreigners, we have been expanding our participation in all areas of the entertainment spectrum, providing local employment and utilizing local goods and services whenever possible. We were the first studio to film on location in the PRC with Steven Spielberg's "Empire of the Sun," and to release an American blockbuster, "The Fugitive," in 1994.

Today, our priorities include support of the local China film industry. Investment in local productions and support of the local creative community preserves our industry's art form. Today we've invested heavily in bringing state of the art multiplex cinemas to more than 30 cities so that consumers could experience quality movie going. We've recently partnered with a local distributor to expedite delivery of high quality DVDs into the market at competitive prices and our International Television Distribution group has partnered with CCTV, bringing American programming to the PRC and Chinese programming to an international audience.

We have invested our resources and capital in China because we believe it has the potential to be a major market for the filmed entertainment industry.

Contrary to some beliefs, the Chinese consumer has not only money to spend, but the willingness to spend it. Of the 1.3 billion people, China boasts an urban population of 38%, which has been growing by one percent annually for the past decade. In the decade post 1989, China's annual GDP growth rate has remained steadily high, between 7 and 14%, the latest figure (for 2004) $1.649 trillion. Consumer spending in 2004 was up 13.3% over the previous year, at $651.8 billion. Disposable income has risen 7.7% for urban residents to $1,138.4 trillion and 6.8% for rural residents, to $651.8 trillion.

And where is this money being spent? $74 billion on dining, another $74 billion on Travel and Tourism; $30 billion on IT items such as PCs, iPods, Digicams, etc., $9 billion on cosmetics and $2 billion on other luxury goods.

Looking at the media space, the Chinese consumers have spent $26 billion on Wireless phone usage, $2.2 billion on Cable TV; $1.2 billion on newspapers, and $298 million on online gambling. Yet with all of this disposable income, the filmed entertainment industry's revenues are several magnitudes smaller, at $180 million. This includes ALL releases, local and foreign.

Based upon other foreign industries prospering in the market, we believe given proper market access as well as IPR support, filmed entertainment can prosper as well. Philips, which has been allowed to make a 100% foreign investment in its China operations, saw its 2003 revenues rise 11.9% from 2002 to 2003, and China represented 20.60% of their worldwide revenue for 2004 or $7.5 billion .

Likewise, Volkswagen has done well in China, where it has been allowed to invest 50% of foreign funds in its venture. Its revenues have grown more than 53% from '02 to '03, in a year where total revenues only grew 4.9%. Dell, Procter and Gamble, Coca-Cola, Yum Brands—all have achieved similar acceptance and financial success in the China Market, and all those companies have been allowed to bring 100% foreign investment capital to do so. Coke's China market share is now 10.70% of its global revenues. Yum Brands is as high as $13.35 %. Clearly, many industries have been allowed to flourish and have tapped into a very lucrative consumer base in China.

Now let's compare this situation to the film distribution industry. The data available illustrates both a clear and compelling story. In 2004, worldwide box office revenues were approximately $25 billion yet, of that, China box office was approximately $62 million or four tenths of one percent of total box office (see appendix – Table 1). Other statistics are encouraging and disheartening at the same time. While the GDP and Urban Per Capita Income has risen steadily, there has been a corresponding decline in box office revenues. While worldwide revenues have shown steady growth from 1998 through 2004, the China box office actually performed slightly lower in comparison to its 1998 level (see appendix – Table 2).

As represented by the MPA member companies. Our issues can be broken down into two components: Market Access and Piracy.

The two are closely coupled. To promote market stability (let alone growth), both areas must be addressed simultaneously to provide a proper foundation for business development. As one of the largest creators and distributors of content around the world, we continue to experience challenges in China to build viable cinema-going, theatrical, home video and television distribution businesses with restrictions that impede acceptable market access and continue to allow the piracy market to develop. Our competitors ARE THE PIRATES. We accept this as most industry sectors do. Theft will always be a component of our business plan. However, theft left unchecked and supported by new technology that facilitates the viral, illegal distribution of our copyrighted works makes it impossible to create a competitive strategy.

What's most encouraging based upon research that Warner Bros. conducted to test the business plan to create a Home Video joint venture with a local partner was that Chinese consumers DO recognize and ARE willing to pay for quality product. In fact, a statistically significant portion of those polled commented that if they knew that they could reliably purchase high quality DVDs that were available at cost competitive prices, they would buy such product and avoid buying pirated product. Also, in some cases consumers today will buy the pirated feature, if they like it, they'll actually seek out a better quality product for their home library and throw out the pirated DVD. Consumers are ready, willing and able to spend their disposable income for the quality they perceive in seeing a movie or buying a DVD, legitimately, when they are able. Consumers have shown us that there is a steady demand and disposable income they will dedicate to legitimate product, provided it's available and cost competitive.

Looking most specifically at our issues, market access restrictions covering both investment options and business development options continue to be severe. Investment restrictions limit our control to operate as we would within a free market and create risk profiles that simply make even minority investments challenging.

China Film HG Corporation, the first-ever Sino-foreign JV entertainment company was created with the goal to construct high quality cinemas in several urban areas to enable local Chinese the ability to experience true cinema, versus the outdated and dirty theatres typically available. But to make these cinemas profitable and justify our construction costs, there must be a consistent flow of locally-produced as well as foreign films available for exhibition.

Current film quotas (approximately 20/year for all foreign film imports and the State is currently evaluating a further reduction to 14) and extremely cumbersome approval processes (covering areas like censorship) make getting a feature to market untenable.

As nice as these theatres are and using a release strategy that would release the title in China at the same time as the U.S., by not having adequate product flow out into the theatrical market on an expedited basis, we simply can't compete with a 2.6 billion disc capacity piracy manufacturing market.

For our theatrical distribution business, namely the entity that negotiates with exhibitors for screens and theatre access (which is State run), their issues revolve around:

Release approvals – which includes specific dates that we are allowed to release a film

The Censorship Process – which by virtue of its complexities and inconsistent guidelines makes getting a film cleared a unique process each time

The Levies that must be paid for importation of the feature, which based on box office returns, renders almost all titles unprofitable

And finally, strict prohibitions on media buying and direct contact with the media to promote the film.

In 2004, our Home Video distribution business created a joint venture with a local distributor to distribute DVDs on an expedited basis and competitively priced ($2.60 USD). These highly produced (not copies of camcordings with people walking through the frame) DVDs are made available in retail outlets that have the same goals as ours: to sell legitimate product at competitive prices and in a pleasing retail environment.

Here too, inconsistent audio/visual licensing parameters for retail licenses, restrictions on foreign ownership, unofficial yet observed caps on foreign home video releases allowed, and import duties all represent obstacles to making this business viable.

Finally, on the piracy front, every title released in the U.S. is available in the piracy market, uncensored, in China. When a title is released in the U.S., it is guaranteed that a pirated camcorder version will be posted onto the internet triggering a massive supply chain with the title being downloaded in China and used as the master to manufacture pirated discs, complete with local subtitling and on the streets within 24 to 48 hours. This is one reason why we are grateful for the recent passing of the Family Entertainment and Copyright Act which makes camcording in the U.S. a felony.

Inconsistent enforcement activities and a recently lowered yet potentially ineffective criminal threshold make protection of our IP almost impossible. This lack of deterrents coupled with inconsistent messaging to consumers only facilitates piracy growth, both of hard goods and via the Internet as broadband access rapidly expands.

Our challenges are summarized as follows with recommendations for action:

Market Access -- Market Reform

Challenges:

- The filmed entertainment industry is one of a few market segments yet to be reformed
- Foreign investment restrictions (minority ownership) inhibit business development
- Distribution of theatrical content is regulated by the State-run entities that maintain tight market access control and cumbersome regulations
    - These include
        - Film quota of 20 titles for all foreign submissions (each Studio may get one or two titles a year)
        - Arbitrary "black-out" periods invoked without notice that restrict importation of foreign films
        - No documented and consistent censorship process (no ratings system available)
- Distribution of home video content is regulated by State-run entities that maintain tight market access control and cumbersome regulations
    - These include:
        - Audio/Visual license approvals are difficult to receive
        - Taxation levels can range from 50 to 75%
        - No documented and consistent censorship process (no ratings system available)
- Distribution of television content is limited by channel ownership restrictions and inconsistent distribution guidelines

Recommendations:

We have experienced first-hand that unless reform is endorsed at the highest levels of government within China, it is unlikely that the State-run agencies will change their current policies. Pressure must be applied for reform to support market access that will facilitate relaxing of restrictions that are listed above.

Piracy

Challenges:

- Massive Optical Disc Manufacturing Capacity (supports pirate market)
    - These include:
        - 2.6 billion disc capacity within China
        - Major exporter and supplier of pirated discs to key EMEA territories
        - Difficulty in tracing product for enforcement purposes
- Lack of Legal Deterrents
    - These include:
        - Highly profitable, often linked to organized crime
        - Criminal Threshold remains high even after modification
        - Low level fines
        - Little to no enforcement of TV or Cable piracy
        - No time limits on investigations
        - Enforcement training still requires support
        - Little to no government public relations messaging regarding IP respect and anti-piracy to consumers
        - Little use of government clout to control piracy yet test cases e.g. Hero show that government can curb illegal distribution
- Growing Internet Piracy
    - These include:
        - +90MM Internet users with +30% using broadband
        - No Internet regulations established to define legal code of conduct and ISP requirements
        - Rapidly increasing peer-to-peer file-swapping that is greater than Europe and the U.S. in absolute volumes
        - Growing number of websites selling content illegally—in some cases hosted by established Chinese service providers whose stock is publicly traded on U.S. Exchanges.

Recommendations:
Whether its film, software, games or the design specifications for making a new automobile, the issue of China's acknowledgement and enforcement of intellectual property rights rest at the core of market access and growth. The U.S. must take a multi-tiered approach by addressing piracy on a legislative, legal or enforcement, market access, consumer awareness and business development perspective. Vice Premier Wu Yi, charged with Foreign Trade, IPR, and health, should be called to task on her publicly made commitments to curb piracy through multiple campaigns. At the 8th China International Fair of Investments & Trade in Xiamen, Vice Premier Wu Yi committed to crackdown on IPR infringement. However, it is unclear if a strategy has been developed and plans put into action to support a long term and robust anti-piracy strategy.

In closing, the filmed entertainment industry and certainly Warner Bros. Entertainment, is willing and able to take up the challenges associated with new market development. But to do so we need market reform and legislative reform that support IP protection and increases enforcement.

In China, the consumer's appetite for filmed entertainment is significant and increasing. Unfortunately, without proper reforms and aggressive enforcement strategies, any new business scenario that we offer will be greatly compromised by an unrestricted and increasingly sophisticated piracy market.

APPENDIX

Table 1

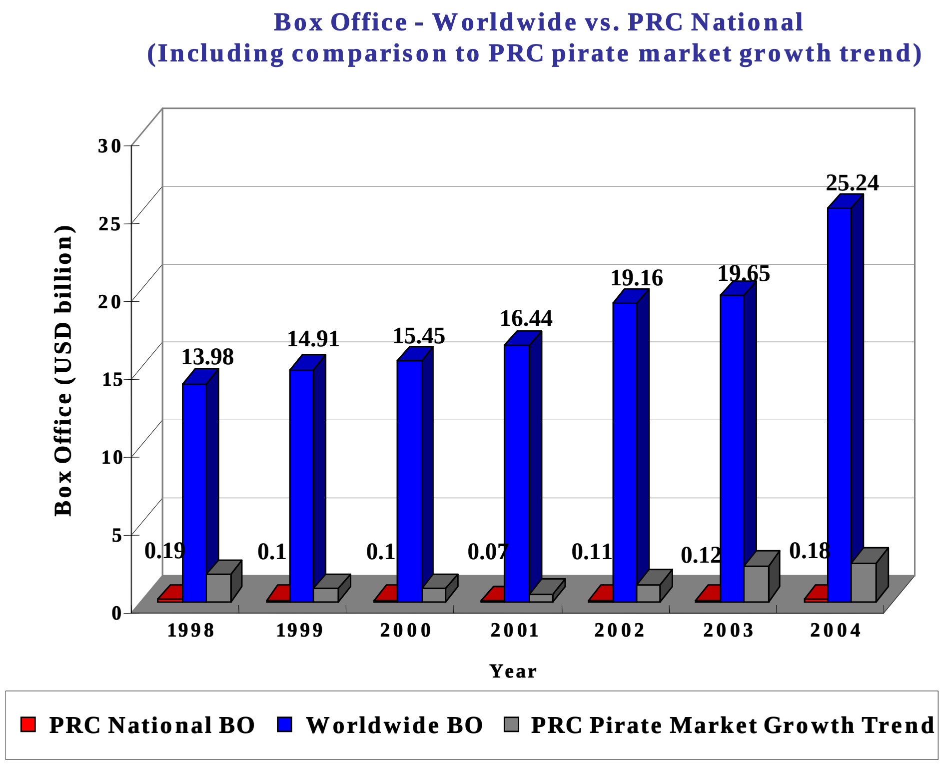

Table 2