

DOW, LOHNES & ALBERTSON, PLLC
ATTORNEYS AT LAW

M. ANNE SWANSON
DIRECTOR OF LEGAL AFFAIRS
202-776-2222

WASHINGTON, D.C.

1200 NEW HAMPSHIRE AVENUE, N.W. - SUITE 800 - WASHINGTON, D.C. 20036-6802
TELEPHONE 202-776-2000 - FACSIMILE 202-776-2222

ONE RAVINIA DRIVE - SUITE 1600
ATLANTA, GEORGIA 30346-2108
TELEPHONE 770-901-8800
FACSIMILE 770-901-8874

October 7, 2002

BY HAND DELIVERY

Marlene H. Dortch, Esquire
Secretary
Federal Communications Commission
445 12th Street, NW
Washington, DC 20554

RECEIVED

OCT - 7 2002

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Re: Notification of Ex Parte Communication
MB Docket No. 02-230

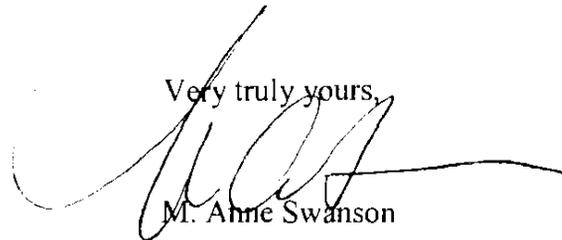
Dear Ms. Dortch:

This is to advise you, in accordance with Section 1.1206 of the FCC's rules, that Emery Simon of the Business Software Alliance, James M. Burger of this firm, and I met today with Rick Chessen and Susan Mort of the Media Bureau.

The discussion involved the Notice of Proposed Rulemaking, released on August 9, 2002 in the above-referenced docket and many of the questions noted therein. Among the specific items under discussion were the identity of the likely participants in the proceeding; the computer industry's concern over the need for use of a "broadcast flag" and the difficulties the FCC will have in defining the appropriate scope of protection; the computer industry's interest in seeing the FCC do no more than adopt functional specifications for the embedding and detecting of a "broadcast flag"; issues associated with the use of "broadcast flags" and "watermarks" in video programming; and the information included in the attached article from this morning's *Washington Post*.

As required by section 1.1206(b), two copies of this letter are being submitted in the above-referenced dockets.

Very truly yours,



M. Anne Swanson

cc (by hand delivery):
Rick Chessen, Esquire
Susan Mort, Esquire

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Hollywood Sees the Big Picture With DVDs

By Frank Ahrens

Washington Post Staff Writer

Monday, October 7, 2002; Page A01 <http://www.washingtonpost.com/wp-dyn/articles/A51962-2002Oct6.html>

"Monsters, Inc.," the animated Disney kids' film, grossed \$255 million at the box office, making it one of the year's biggest hits.

But as a revenue monster, it is just starting to howl.

On Sept. 19, the film's DVD, or digital video disc, was unleashed on the market. In its first week, it sold 7 million copies at an average price of \$20, setting a record.

In today's Hollywood, box office revenue makes up less than a quarter of a film's total take. The largest piece of a movie's money pie comes from sales and rentals of its DVDs. If "Monsters, Inc." meets only routine DVD projections, Walt Disney Co. and Pixar Inc., which is part-owned by Disney, will end up splitting more than \$380 million, far outstripping what the movie earned in theaters.

Witness the surging economic engine of Hollywood: the DVD.

For the first time this year, revenue from sales and rentals of DVDs, also known as digital versatile discs, has passed that from videotapes, partially because of the superior sound and picture quality of DVDs, but also because the discs are packed with features not available on video.

The DVD is changing more than Hollywood's bottom line. It is influencing what kinds of movies get made and when they are offered for sale and rental. It is extending the creative control of the director beyond the theater. It is affecting consumer choices -- some new films are no longer for sale on video, only on DVD.

On the downside, the studios' increasing reliance on DVD sales and rentals makes them more dependent on retailers, who are eager for a larger portion of profits. As a result, studios are developing alternative distribution options, such as cable television's video-on-demand service, to circumvent the video outlets.

But those problems pale in comparison to the deep gold mine that DVDs have become.

"We're all making a lot of money on DVD," a veteran studio executive said.

Breaking Revenue Records

When movie videos launched nearly 20 years ago, studios made almost all of their revenue from a movie's theatrical release and subsequent sales to television. Video revenue was seen as gravy. As the VCR grew in popularity, video rentals helped salvage movies that tanked at the box office.

But DVDs have done much more.

Machines playing the small discs have been embraced by consumers faster than any other electronic device, including the cell phone and the personal computer, as prices of both players and discs have plummeted. In the first half of 2002, DVD sales and rentals raked in about \$2.6 billion for all Hollywood films. Those same films earned \$1.7 billion in theaters and \$1.6 billion from video.

People tend to buy more DVDs than videos; households owning DVD players will buy an average of 16 discs this year, while households owning VCRs will buy an average of five tapes.

Anal industry estimates indicate that consumers will spend nearly three times as much on DVD sales as rentals this year, paying an average of \$88 per household to rent DVDs and \$261 to buy them.

Typically, studios receive about 40 percent of a DVD rental charge, which usually runs from \$3 to \$5. The studios get about 33 percent from the sale of a DVD. For top-line DVDs such as "Harry Potter and the Sorcerer's Stone," which can sell for as much as \$29.98, the studio will clear \$9.98 per disc.

Because of the coming release of blockbusters such as "Spider-Man," "Star Wars: Episode II -- Attack of the Clones," "XXX" and "Scooby-Doo," Hollywood is anticipating its biggest DVD fourth quarter yet. The next first-day sales record is likely to be set by Sony's "Spider-Man" DVD, to be released Nov. 1. The studio has shipped 19 million DVDs to Wal-Mart Stores Inc. and other retailers.

"The bigger pictures are even bigger, therefore there is more pressure to create better pictures and pay more money for bigger stars and special effects," said Benjamin Feingold, president of Columbia TriStar Home Entertainment, a division of Sony. "We have to increase the 'wow' factor."

For consumers, that means getting more than just a movie. The "Monsters, Inc." DVD has so much extra content, it takes up two discs. In addition to the movie, consumers get two short films, a game, a music video, interviews with the moviemakers, outtakes, abandoned story concepts, a tour of the Pixar animation studio, a trailer for an upcoming animated film, an explanation of computer animation and more.

So lucrative have the discs become that retailers are beginning to vie for a piece of the action. Blockbuster Inc., owned by Viacom Inc., which has its own movie studio in Paramount, is the largest player, controlling about 52 percent of the DVD rental market with its 8,000 stores.

As the DVD has grown in popularity, so has the clout of video stores. Blockbuster once had to agree to share revenue and buy a studio's entire catalogue of DVD and VHS releases to secure the hottest titles. Now, the retailer has more leverage. It still buys some studios' entire DVD outputs and shares sales revenue, but with other studios it buys DVDs on a title-by-title basis and does not share revenue. Further, Blockbuster does not share DVD rental revenue with the studios.

"They chose to bring the DVD in at a price so low that revenue sharing made no sense for us," said Dean Wilson, Blockbuster's executive vice president for content worldwide.

To sidestep Blockbuster, some studio executives, including Warren Lieberfarb, president of Warner Home Video Inc. and father of the DVD, are proposing that their industry exploit soon-to-be-launched video-on-demand services, called Movielink and Movies.com, to offer consumers movies for rental or sale over high-speed Internet access. No more trips to the video store, no more discs or tapes.

"They put us in a position of having to control our own destiny and develop a different business model that makes us less dependent on them," Lieberfarb said.

A New Way of Marketing

Lieberfarb, whose Warner Bros. team invented the DVD 10 years ago, is a gleeful provocateur who dragged the movie studios kicking and screaming out of the videotape era and into the DVD age, at least partly because Warner Bros. has several patents on DVD technology. White-haired and professorial with a droll wit, he is described in Hollywood as a visionary.

But no one could have envisioned the DVD frenzy. In the first half of 2001, DVD rentals and sales accounted for 23 percent of the movie industry's total take. In the first half of 2002, the percentage was up to 34 percent and climbing. Sales of both video movies and blank videotapes have dropped in the past year, reports the Electronic Industries Alliance trade group, as the video has started going the way of the eight-track.

DVDs are changing the way studios market movies. Sony's Columbia Tristar studios recently released the Jodie Foster thriller "Panic Room." Television commercials urge consumers to "buy it now on DVD, rent it on video." That is because Sony made no video copies for sale, guessing that the consumer most likely to buy "Panic Room" would play it on DVD. By parsing its consumers into "DVD buyers" and "video buyers," Sony can maximize its profits.

Major retailers are also changing the way they think. Last summer, Circuit City Stores Inc. announced it would no longer sell movies on video, ceding the rack space to DVDs. Best Buy Co. has pared back its stock of videos while expanding its DVD catalogue. In Blockbuster stores, where DVD rentals will exceed VHS rentals by year's end, DVDs are no longer segregated from video. The chain has acknowledged the growing desire for DVDs by displaying them side by side with videos.

VCRs are in about 90 million U.S. homes, essentially a level of saturation. DVD players are in 31 million U.S. homes, up from 17 million this time last year, Warner Home Video said. During the past five years, the average price of a DVD player has dropped to \$153 from \$491, the Consumer Electronics Association trade group said.

The quick acceptance of DVDs stems in part from the ease and cheapness of digital copying. In the early days of videotape, it cost about \$25 per tape to duplicate a movie from one tape to the next. That is why videotape rentals quickly surpassed the sales market -- consumers could rent a videotape for \$4, but had to pay as much as \$99 to buy it.

DVDs cost less than \$1 to duplicate and, unlike videotapes, they can store more data. This means the studios can add features on a DVD that movie fans cannot get on videotape.

"For a long time, the home entertainment divisions were in a linear business -- they'd take what was released theatrically, put it on tape, then out with it," the veteran studio executive said. "Now, we're in the business of creating a new product."

A Director's Dream

In places like Sony's Digital Authoring Center at its sprawling Culver City studios west of downtown Los Angeles, the DVD goes from being just a movie to an "experience," as they say.

First come the meetings, sometimes beginning a year before the DVD is set to release.

At all studios, not just at Sony, the team that creates the DVD gets a budget from the studio's marketing department, which relies on formulas to estimate how many DVDs a movie is likely to sell. Then, the DVD team hires a producer to bring together all of the added content that will go on the disc -- interviews, featurettes and so on.

The DVD team will meet with the director -- often before the film has begun shooting, yet another way the DVD is changing Hollywood.

"It's amazing," said Michael Stradford, Sony's vice president of DVD programming and content. "When I first joined the company in 1998 and would meet with directors, I would have to take a portable DVD player to explain how the format would work and why it's a really good thing to support it. Now, they're calling, saying, 'Hey, I want to talk to you about the DVD' before the film is shooting."

Often, moviemakers want to add so many extras that a second disc is required, which turns out to be a drop in the budget bucket: A studio executive said the cost of adding a second disc ranges from \$50,000 to \$200,000 per movie, depending on how much content is added.

Sony's "Spider-Man" DVD will likely raise the bar for the amount and quality of added content. In addition to the features showing how the film's extensive special effects were created, a screen test of star Tobey Maguire, commentary from romantic lead Kirsten Dunst and a documentary of the comic's history, the second disc is to contain renderings of Spider-Man by a number of artists, offering homage to creator Stan Lee.

If the consumer has embraced the DVD because of its superior picture and sound and extra features, one of the reasons moviemakers have done so is because of ego.

Because DVDs can be packed with scenes the director shot that were edited from the movie, the discs can turn the movie into a vanity project, allowing the director to have the last word.

At after-market shops like Sony's, egos are intruding in other ways. One film's director, whom the shop's employees declined to name, was unhappy that he did not show up enough in the additional material. To rectify the lapse, he directed them to insert more footage of him directing the film.

At a Market Near You?

The next generation of DVDs will be HDDVDs, or high-definition DVDs, made to be seen on high-definition televisions that now, at more than \$2,000 each, are in a relative handful of homes. But as their price inevitably comes down, spurred by federal regulations requiring the switch to digital television, the quality of DVDs will have to ratchet up accordingly.

Inside the players, the red laser that reads the DVDs will, when the cost becomes viable, be replaced by a blue laser, which promises an improved picture and more data storage on a single disc.

But the next big thing consumers may notice are DVDs in the checkout lines of supermarkets and drug stores. Some of the major studios are discussing deals with such retailers to stock DVDs. If Lieberfarb and Warner Bros. get their way, the DVD will dive as low as \$10 a disc, another Lieberfarbian agitation that provokes the other studios.

"It will be priced so it will be an impulse purchase," he said.

Which means that soon, Lieberfarb hopes, DVDs will be priced so low that the once-exotic disc - as little as five years ago, a curiosity in the homes of early-tech adopters -- will be as ubiquitous and inexpensive as a tube of lipstick or two packs of D-cell batteries.