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WORKING LANGUAGE

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<u>Subject:</u> **State aid C 25/2009 (ex N 673/2008) – Italy**
Film investment & distribution tax incentives: State aid approval
Digital cinema tax credit: Opening of formal investigation

Sir,

1. SUMMARY

(1) I am pleased to be able to inform you that the European Commission has decided to give State aid approval to Italy's film investment and distribution tax incentives until 31 December 2010. This approval is subject to the following commitment made by the Italian authorities:

- The Italian authorities will implement any changes that may be required after the expiry of the current State aid criteria in the Commission's Cinema Communication[1].

(2) At the same time, the Commission has certain doubts about the necessity, proportionality and adequacy of the proposed tax credit for investment in

1 Communication from the Commission to the Council, the European Parliament, the Economic and Social Committee and the Committee of the Regions on certain legal aspects relating to cinematographic and other audiovisual works (COM(2001)534 final of 26/9/01,OJ C 43 pp6-17 of 16/2/02); prolonged in 2004 (OJ C 123 pp1-7 of 30/4/04), 2007 (OJ C 134 p5, 16/6/07) and 2009 (OJ C 31 p. 1, 7/2/09)

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digital projection equipment and therefore opens a formal investigation into the measure.

(3) This decision complements the approval in December 2008[2] of the first part of Italy's comprehensive package of film tax incentives. The aspects already approved are not included in the notified scheme and are therefore not considered in this decision.

2. PROCEDURE

(4) The Italian authorities notified the European Commission of the proposed scheme on 30 December 2008. The Commission requested additional information on 19 February 2009, to which the Italian authorities responded on 2 April 2009. The Commission requested further information on 2 June 2009, to which the Italian authorities responded on 23 June 2009.

3. DESCRIPTION

(5) The current notification includes a number of fiscal measures for various activities related to the film sector:

a) a tax credit for businesses outside the film sector investing in the production of "Italian" cultural films;

b) a tax relief for businesses outside the film sector reinvesting profits in "Italian" cultural films;

c) a tax credit for film distributors and exhibitors[3] investing in the production of films of special cultural interest;

d) a tax credit for film distributors investing in the distribution of "Italian" cultural films;

e) a tax relief for film distributors reinvesting profits in the distribution of "Italian" cultural films; and

f) a tax credit for exhibitors installing digital projection equipment.

(6) This package of tax incentives is intended by the Italian authorities to stimulate the market dynamics to support "Italian" cultural films in an environment conducive to competition and to promote such films in Italy and Europe. The same verifiable national criteria examined by the Commission in its December 2008 approval of the Italian film production tax incentives are applied to define "Italian" cultural films and films of special cultural interest.

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2 State aid case N595/08

3 An exhibitor is a business which operates one or more cinemas. Each cinema operated by an exhibitor may have one or more screens.

(7) The Italian authorities consider that incentives (a) & (b) will help increase the independence of small producers from television networks, by attracting private investment from outside the film sector. They aim to relieve film producers from the commercial needs of such networks and allow them to focus on the quality and cultural nature of the film.

(8) The Italian authorities believe that incentives (c)-(f) will help to support "Italian" cultural films, both for their promotion and for their release in cinemas, even when these films are not produced by international or national majors. These incentives aim to stimulate the creation of a "project network / partnership" between producers, distributors and exhibitors.

(9) The Italian authorities have provided data to support the need for this type of intervention. The market share of independent "Italian" cultural films is low (11%-15% in 2005-2007). That of films of special cultural interest is very low (2%-6% in 2005-2007).

(10) According to the Italian authorities, in recent years, distortions in the Italian film market have increasingly threatened the cultural identity of Italian cinema. This has had the effect of stifling its creative force, impoverishing its productive capacity and limiting its reach both within Italy and across Europe. The pulverization of the Italian film sector - characterised by small, low capital businesses with a high mortality rate - combined with a strong presence of the US majors in distribution, and for some years also in production, has created a strong presence of mainly US commercial films with high budgets.

(11) Over the years, Italy has increasingly set up a film sector incapable of supporting products filmed in a cultural matrix. These are characterised by a limited audience appeal and increasing production costs. According to the Italian authorities, the Italian market is tending to set up a near dominant position for few big, corporate, reality-oriented, commercial film products.

(12) The legal bases for the scheme are*:*

- *Legge 24.12.2007 n. 244*[4] *(disposizioni per la formazione del bilancio annuale e pluriennale dello stato - legge finanziaria per il 2008): articolo 1, commi da 325 a 343, con specifico riferimento alle misure previste nei seguenti commi: comma 325 - comma 327, lettere b e c - comma 338 (limitatamente a imprese di distribuzione cinematografica) nota: il comma 325 e il comma 327, lettera b), e), c) dell'art. 1 della legge n. 244/2007, abrogato dall'art. 5, comma 9, lett. A) del decreto-legge 27.5.2008, n. 93, sono stati ripristinato dall'art. 63, comma 13-ter, del decreto-legge 25.6.2008, n. 112, convertito con modificazioni dalla legge 6.8.2008, n. 133 disposizioni di applicazione: schemi di decreti interministeriali di attuazione ministero beni e attività culturali - ministero dell'economia e delle finanze (art. 1, commi 333 e 340, legge n. 244 del 2007) con allegate tabelle.*

[4] Pubblicata nella Gazzetta Ufficiale della Repubblica Italiana 28.12.2007, serie generale n. 300, supplemento ordinario n. 196

(13) The Commission notes that the text contained in financial law 244/2007 in fact quotes only the criteria provided for in articles 5 and 7 of legislative decree 28/2004, while the sub-decrees would impose additional requirements, particularly concerning cultural criteria. The Italian authorities have drawn attention to the fact that based on what already provided for in Italian law n. 100 of 1926, and successively by art. 17 of law n. 400 of 1988 for the implementation of legislative provisions, governmental or ministerial decrees may be issued. Such decrees are the expression of normative powers attributed to the Administration, secondary to primary legislative provisions to which they refer completing the regulations. According to the Italian authorities, they, in fact, discipline, in abstract, types of legal relations, by regulating the implementation and integration of the primary laws, equally innovative compared to the existing legal system, with general and abstract rules.

(14) In the view of the Italian authorities, the cultural criteria in the sub-decrees related to the current scheme must not be interpreted as an additional requisite to those already foreseen in articles 5 and 7 of legislative decree n. 28/2004, but, on the other hand, as a specification of the requisites outlined in the primary law for a concrete implementation of the same. The criteria and requisites specified in the sub-decrees are, therefore, an integral part of the scheme and are binding on potential beneficiaries.

(15) The estimated budget of the scheme is €48 million in 2009 and €50.5 million in 2010. The overall budget of the scheme is therefore €98.5 million.

(16) This overall budget is divided as follows between the different measures within the scheme:

	Tax credit/relief (€ million)
Tax credit for businesses outside the film sector	36
Tax credit for distributors/exhibitors investing in the production of films of special cultural interest	4.4
Tax credit for distributors investing in the distribution of films of special cultural interest	15
Tax credit for distributors releasing "Italian" cultural films	7.4
Tax credit for exhibitors installing digital projection equipment	16.8
Tax reliefs for businesses outside the film sector and for distributors	18.9

3.1. Mechanism

(17) The fiscal measures apply to companies which are liable to tax in Italy. The tax credits are available against all types of taxes. The tax reliefs reduce the taxable income of eligible companies making the relevant qualifying investments.

(18) For the purposes of these measures, EEA citizens are considered to be equivalent to Italian nationals. Similarly, all national or foreign films that, even under co-production agreements, have the characteristics to obtain

recognition of Italian nationality may be considered to be "Italian" films for the purposes of the measures, if their production companies so wish.

3.1.1. *Film tax incentives for businesses outside the sector*

(19) The following tax credit and tax relief are available to businesses outside the film sector which invest in "Italian" cultural films:

	Tax credit/relief available	Maximum annual tax credit/relief per beneficiary
Tax credit	40% of the amount invested in the production of such films	€1 million
Tax relief	30% of the declared profits reinvested in the production and distribution of such films	-

(20) The eligible investment is limited to 49% of the production budget of the film and 70% of the declared profits. 80% of the aid must be spent in Italy.

(21) The maximum aid intensity is therefore [40% x 49% =] 19.6% of the production budget.

3.1.2. *Tax credit for distributors and exhibitors investing in specialised films*

(22) The following tax credit is available to film distributors and exhibitors which invest in the production of films of special cultural interest:

	Tax credit available	Maximum annual tax credit per beneficiary
Tax credit	20% of the amount invested in the production of such films	€1 million
Tax credit (distributors only)	15% of the amount invested in the distribution of such films	€1.5 million

(23) The eligible investment is limited to 49% of the production budget of the film and 70% of the declared profits. 80% of the aid must be spent in Italy.

(24) The maximum aid intensity is therefore [20% x 49% =] 9.8% of the production budget.

3.1.3. Tax incentives for distributors releasing "Italian" cultural films

(25) The following tax credit and tax relief are available to film distributors which invest in the distribution of "Italian" cultural films:

	Tax credit/relief available	Maximum annual tax credit per beneficiary
Tax credit	10% of the amount invested in the distribution of such films	€2 million
Tax relief	100% of the declared profits reinvested in the production and distribution of such films	-

(26) There are no limits on the eligible investment for either the tax credit or the tax relief. So the maximum aid intensities are 10% for the tax credit and 27.5% (the Italian corporate tax rate) for the tax relief.

3.1.4. Digital cinema tax credits

(27) The following tax credit is available to exhibitors which invest in installing digital projection equipment:

	Tax credit available	Maximum annual tax credit
Tax credit	30% of the amount invested in installing such equipment	€50,000 per screen

(28) The notified scheme offers a 30% tax credit for the costs of introducing digital projection equipment in all of the 3,957 screens in Italy. The support would be unconditional for cinemas with between 1 and 4 screens and for multiplex cinemas with between 5 and 10 screens in towns with a population of 50,000 or less. For other multiplexes up to 24 screens, there would be an obligation to show cultural films for 50% of the screenings and to convert at least 50% of the screens to digital projection as a condition of the aid.

3.2. Maximum cumulative aid intensity

(29) The maximum cumulative aid intensity available under the scheme is 50%, except in the case of difficult or low budget films.

(30) The Italian authorities have defined difficult films as being the first and second feature films of a particular director, documentaries, short films and cultural films which have achieved a minimum score of 70 out of 100 in the cultural test for films of special cultural interest and have been judged by the Italian Film Commission as being films which have severe problems in accessing funding and in accessing a wide audience.

(31) The Italian authorities have defined low-budget films as being those with budgets of up to €1.5 million.

4. ASSESSMENT

4.1. Existence of aid

(32) According to Article 87(1) EC, save as otherwise provided in the Treaty, any aid granted by a Member State or through State resources in any form whatsoever, which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall be incompatible with the common market, in so far it affects trade between Member States.

(33) ***Involvement of State resources:*** The source of funding is tax incentives offered by the Italian State so, as the Italian State would be foregoing certain tax revenues, the scheme involves State resources.

(34) ***Economic advantage to an undertaking:*** Under the scheme, businesses investing in film production, distribution and/or exhibition benefit from a financial advantage in the form of tax incentives from the State. They would not receive this advantage under normal market conditions and would have to bear the entire costs of their activities without State funding. Therefore, the scheme provides an economic advantage to the beneficiaries.

(35) ***Distortion of competition and selectivity:*** The scheme is selective in nature as the only beneficiaries of the scheme are businesses investing in film production, distribution and/or exhibition activities. The beneficiaries compete with other undertakings which do not necessarily benefit from the scheme. Consequently, the scheme distorts or threatens to distort competition.

(36) ***Effect on Community trade:*** In view of the international trade in films and in particular in feature films, the Commission considers that the selective advantage provided to companies investing in film production, distribution and exhibition under the scheme may affect intra-community trade.

(37) Consequently, the scheme constitutes State aid within the meaning of Article 87(1) EC.

4.2. Compatibility

(38) The State aid criteria of the Cinema Communication[5] provide special rules for assessing aid for film and audiovisual production under article 87(3) (d) of the EC Treaty. As well as applying the 'general legality' principle, these criteria require that:

- the aid is directed towards a cultural product, applying verifiable national criteria;
- the producer must be free to spend at least 20% of the film budget in other Member States;

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5 See footnote 1.

- the maximum aid intensity is 50%, except for difficult and low budget films; and

- the scheme does not provide aid supplements for specific film-making activities.

(39) These criteria are therefore applicable to the measures within the notified scheme which concern investment in film production. However, the support for film distribution and digital cinema under the scheme cannot be assessed with these criteria. The necessity and proportionality of these measures are therefore considered separately.

4.2.1. General legality principle

(40) The Commission has to verify that the scheme does not contain clauses that would be contrary to Treaty provisions in fields other than State aid.

(41) The fiscal nature of the mechanism means that potential beneficiaries would need to have taxable income in Italy to take advantage of the tax relief. The requirement to be liable to national taxation is a common feature of fiscal incentives. However, this scheme does not limit the tax credits or the tax reliefs to expenditure in Italy. Consequently, there is no additional incentive for territorial spending in the scheme.

(42) On the basis of the information provided by the Italian authorities, the notified scheme does not raise any particular issues in this respect. Territorial conditions regarding film production expenditure are dealt with under the Cinema Communication in the appropriate sections below.

4.2.2. Film production tax incentives for businesses outside the sector

(43) The tax credit and tax relief for businesses outside the film sector are only available for investment in the production and distribution of "Italian" cultural films. The objective of the aid is to stimulate outside investment in the production of cultural films.

(44) The resulting support for film production can therefore be assessed under the Cinema Communication criteria. Since a 40% tax credit is available to businesses outside the film sector (compared to the 15% tax credit already approved by the Commission for film production companies), the Commission also has to consider the impact of the measure on the direct beneficiaries of the tax credit.

(45) The cultural criteria applied by the Italian authorities in defining "Italian" cultural films and films of special interest have already been examined by the Commission in its approval of the Italian film production tax incentives. Since the same criteria are applied to these measures, the aid is directed towards a cultural product, applying verifiable national criteria.

(46) A condition of the tax credit is that 80% of the investment is spent within Italy. Since the maximum eligible investment is 49% of the production budget of a film, this territorial condition concerns at most 39.2% of the production budget. There is no territorial condition attached to the tax relief. Consequently, the producer is free to spend well over 20% of the film budget in other Member States without the aid available under these measures being reduced.

(47) The maximum cumulative aid intensity for the film production remains 50% and the aid is not directed towards specific film production activities. Consequently, all of the State aid criteria of the Cinema Communication are met.

(48) Since the objective of these measures is to attract investment from outside the film sector to the production and distribution of films meeting specific cultural criteria, this objective is in line with Article 151 of the EC Treaty, which provides that "the Community shall take cultural aspects into account in its action under other provisions of this Treaty, in particular in order to respect and to promote the diversity of its cultures."

(49) According to the Italian authorities, the Italian film market is characterised by a chronic inability to attract private funds from outside the sector, whether in the form of loans or venture capital. This leads independent producers to be heavily dependent on financing from either major production companies or from television companies. The effect is to increase the concentration of market shares combined with difficulties faced by independent producers of covering the remaining gap in production budgets.

(50) The Commission shares the belief of the Italian authorities that, in general, a system of State aid can be considered virtuous when it stimulates competition and is considered temporary and able to create market dynamics that can endure over time even after the cessation of aid. In the view of the Italian authorities, the objective of these measures is to introduce a form of support which can create and consolidate the relationship between private investors and the film sector, with the ultimate goal of providing businesses with film financing alternatives other than public funding and the resources of major media groups.

(51) To create this stimulus, the Italian authorities believe it is necessary to introduce a higher tax credit than that available to film production companies, although with a lower eligible investment limit. The rationale behind this choice is motivated by two specific economic reasons:

- asymmetric information between businesses within the film sector, particularly production companies, and businesses outside the sector, which have less knowledge of the film market and less awareness of the production and distribution processes and the risks associated with them; and

- the need to avoid a dangerous concentration of credit risk on the individual investor.

(52) The Italian authorities note that these economic determinants characterise all investments in film production but are even more relevant for cultural films, especially in relation to the risk/return trade-off, which is clearly lower for such films than for more commercial films.

(53) The Italian authorities therefore believe that the existence of an information gap exposes an investor from outside the film sector to greater risk. Such an investor also has less influence over the production process to limit these risks than the film production company. This is the justification for the higher risk premium available to investors from outside the sector investing in film production. It also explains why the eligible investment is limited to €1 million per year, per company.

(54) The Italian authorities consider that the combination of a high tax credit and a low annual maximum investment facilitate private investment in film production of a cultural nature, ensuring a proper risk-return combination and at the same time limiting the risk exposure of the individual investor.

(55) The Italian authorities have provided an economic analysis based on data for cultural films and for more commercial films released in Italy in 2005-2007 to demonstrate that the figure of 40% represents the difference between the lower return on cultural films compared to that on more commercial films. This explains the choice of 40% for the tax credit available for investment by investors outside the sector in "Italian" cultural films.

(56) The rate of 20% selected by the Italian authorities for the tax credit available to distributors and exhibitors investing in films of special cultural interest is half of the 40% figure. The Italian authorities explain this lower tax credit by the fact that distributors and exhibitors face a lower exposure to asymmetric information because of the nature of their core business.

(57) The Italian authorities note that this mechanism is novel among the EU Member States and that they consider the 40% rate to be experimental. The Italian authorities will closely monitor the microeconomic and macroeconomic effects of the measure during its period of operation. The Italian authorities will amend the measure if necessary in the Budget Law of 2011 to correct any potential distortion of competition which may emerge.

(58) The Italian authorities have also committed to incorporate, in the decrees implementing the measures, a mechanism to avoid possible "abuses" of the measure which could treat a commercial agreement between an investor outside the film sector and film production company as an eligible investment. The mechanism is to put as condition for granting the tax credit to an outside investor (not manufacturer) that makes even product placement in that film, a minimum investment threshold equal to 10% of the production budget (reduced to 5% in the case of difficult or low budget films). In order to monitor compliance with this threshold, mechanisms requiring accounting

separation between an investment in a film production and a commercial agreement[6] will be imposed on investors and producers.

(59) The Commission therefore considers that the tax credit and tax relief for businesses outside the film sector investing in film production is necessary and proportionate to the cultural objective of the measure and is compatible with the EC Treaty under the cultural derogation of Article 87.3(d).

(60) The tax relief for businesses outside the film sector investing in the distribution of "Italian" cultural films is considered in section 4.2.4 with the tax incentives for distributors releasing such films.

4.2.3. Tax credit for distributors and exhibitors investing in specialised films

(61) The 20% tax credit for distributors and exhibitors is only available for investment in the production of films of special cultural interest. The tax relief for distributors is only available for profits reinvested in the production of "Italian" cultural films. The objective of the measures is to stimulate the investment by distributors and exhibitors in the production of such films.

(62) Applying a similar reasoning to that in section 4.2.2, the 20% tax credit available to distributors and exhibitors investing in the production of specialised films is compatible with the EC Treaty under the cultural derogation of Article 87.3(d).

(63) The tax relief for distributors reinvesting profits in the production of "Italian" cultural films applies the same conditions as the tax relief for producers reinvesting profits in such films, which has already been approved by the Commission. Consequently, applying the reasoning in that decision, the Commission considers that the tax relief for distributors investing in the production of "Italian" cultural films is compatible with the common market on the basis of Article 87 (3) (d) EC as it fulfils the conditions set out in the Commission's Cinema Communication.

4.2.4. Tax incentives for film distribution

(64) The Italian authorities have notified four tax incentives for film distribution within the scheme: the 10% tax credit for distributors releasing "Italian" cultural films; the 15% tax credit for distributors releasing films of special cultural interest; the 30% tax relief for businesses outside the sector to invest in the distribution of "Italian" cultural films and the tax relief for distributors and production companies reinvesting profits in the distribution of "Italian" cultural films.

(65) The objective of these measures is to stimulate the distribution of such films. Consequently, this objective is in line with Article 151 of the EC Treaty[7].

[6] Such as a product placement agreement between a business and a film producer.

(66) As mentioned above[8], the Italian authorities have provided data confirming the consistently low market share of "Italian" cultural films and the very low market share of films of special cultural interest. These confirm the necessity of State aid to support the distribution of such films.

(67) The Commission also notes that the need to support the distribution of European films was recognised in the 1994 report of the Commission Think Tank on audiovisual policy in the EU[9]. The poor circulation of European films was also recognised in the 2005 report of the Copenhagen Think Tank on European film and film policy[10].

(68) In May 2009, the *Focus 2009* report of the European Audiovisual Observatory[11] showed that the number of European films produced had reached a record high of 1,145 films in 2008, although the average market share of European films was 28.4%. The same report showed that Italian films accounted for only 3.6% of cinema admissions across the EU.

(69) The different levels of tax credit available to distributors reflect the difference in market shares (and hence financial risk) associated with the release of these types of films within Italy. The Italian authorities consider that 10% and 15% are the appropriate levels of additional incentive required to encourage distributors to release such films rather than more commercial alternatives.

(70) Therefore, the Commission considers that the distribution support within the scheme is necessary and proportionate to the objective pursued and does not distort competition to an extent which would be contrary to the common interest in line with Article 87(3)(d) of the EC Treaty.

4.2.5. Digital cinema tax credits

(71) The Commission indicated in its Communication of 28 January 2009 extending the validity of its State aid assessment criteria for film production support schemes that the issue of public support for digital projection is an area in which the Commission has not yet defined a policy. As the Italian tax incentive for digital projection is the first such scheme to be available primarily to commercially successful exhibitors, there is no obvious precedent the Commission could follow to assess the scheme. On a wider level, the issue of public support for digital projection is quite a complex topic potentially requiring major public intervention on which there has so far been no public consultation at EU level.

(72) The Commission has previously examined measures to support the installation of digital projection equipment under specific conditions:

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7 See extract in paragraph (48).

8 See paragraph (9).

9 http://ec.europa.eu/avpolicy/docs/library/other/think_tank_1994.pdf

10 http://filmthinktank.org/fileadmin/thinktank_downloads/CopenhagenReport2007.pdf

11 http://www.obs.coe.int/online_publication/reports/focus2009.pdf

- ***UK Digital Screen Network***[12]: Cinemas receiving the aid were required to show a high proportion of specialised films using the digital projection equipment being installed. In that case, the Commission applied the cultural derogation of Article 87.3(d) of the EC Treaty on the basis that this condition ensured that the aid promoted the exchange and distribution of cultural goods without affecting trade and competition to an extent that is contrary to the common interest.

- ***Finnish support for digital cinema***[13]: The Finnish authorities applied the *de minimis* rules to the support given to cinemas in small localities. Multiplexes and cinemas which were part of a larger chain in medium-sized municipalities were excluded from the aid, except in limited economic circumstances. Multiplexes and cinemas which were part of a larger chain in the capital area were also excluded from the aid. Arthouse cinemas and 1-3-screen cinemas were eligible for support in any location. In that case, since the support was aimed at providing financial support to activities which are related to technical activities in the audiovisual sector, the Commission applied Article 87.3(c) of the EC Treaty.

(73) As a result, the Commission would need to assess the compatibility of the Italian tax credits for digital cinema under either Article 87.3(c) of the EC Treaty or under the cultural derogation of Article 87.3(d). Both require the Commission to consider the necessity, proportionality and adequacy of the aid.

Necessity

(74) The Italian authorities have noted that cinema audiences would not be able to see any significant improvement in picture quality between the existing 35mm projection equipment and digital projection. While this was stated to argue that there would be no additional box office revenue from digitisation, it also raises the question of why support for digital projection is necessary.

(75) At the same time, the Commission is aware from earlier notifications by other Member States that the flexible programming which is possible with digital projection could offer significant improvements in the choice of films available to cinema audiences and hence to the box office revenues of cinemas. Consequently, there is general interest in installing digital projection equipment and, once a critical mass of cinemas have converted to digital projection, normal market forces would imply that films are distributed only in digital form because of the lower costs of digital distribution for distributors (€150 per digital print plus transmission costs instead of €1,000 per 35mm print per screen, according to the Italian authorities).

(76) The Commission is also aware that the pace of digital conversion of cinemas across the EU has been extremely slow, *inter alia* because of the high cost of the digital projection equipment. The Italian authorities have indicated that the

[12] State aid N477/04
[13] State aid NN70/06

cost of installing digital projection equipment would be €100,000 per screen for a 2K DCI[14] installation which could also show 3D digital films.

(77) However, the maximum tax credit for digital conversion of €50,000 per screen corresponds to a maximum eligible installation cost of [€50,000 ÷ 30% =] €166,667 per screen, given the 30% tax credit available. Consequently, the Commission doubts whether the maximum tax credit should need to be so high.

(78) Even the figure of €100,000 would imply an overall investment of [3,957 x €100,000 =] €395.7 million. Extrapolating this figure to the 33,000 cinema screens across the EU would suggest that an EU-wide investment of €3.3 billion would be required for complete digital conversion. In the current economic climate, the Commission doubts that this level of investment would be available to all cinema screens in all EU Member States, whether from public or private sources.

(79) As far as the Commission is aware, the digital projection equipment which would need to be installed comprises, in essence, a digital projector, computer storage and cabling. The most expensive component of this equipment appears to be the digital projector. So, even if public support for digital cinema would be necessary in Italy, the Commission must still assess whether €100,000 per screen is a fair estimate of the necessary costs of installing digital projection.

(80) The Commission is also aware[15] that the installation of digital projection equipment allows cinemas to screen not only digital films but also other types of digital content, such as live opera, theatre, football matches, mass gaming and digital commercials. Those distributors providing such 'alternative digital content' do not appear to require DCI-compliant digital projection equipment[16].

(81) The Italian authorities have provided data for the 1.3K digital projection in the 67 screens of the Microcinema circuit, which screened 75 films and 18 opera shows from April 2007 to November 2008. 71% of the films shown were Italian or European. By comparison, none of the 46 2K digital releases between 2007 and 2008 were Italian[17]. Only four of the 2K digital releases had a 3D version.

(82) On the basis of these data, it would appear that 2K DCI-compliant projection equipment is not necessary to release Italian or European cultural films. The

[14] DCI refers to the DCI specifications, originally defined for the US market in 2005 by a joint venture of the US film majors (namely Disney, Fox, Paramount, Sony Pictures Entertainment, Universal and Warner Bros. Studios) called Digital Cinema Initiatives: www.dcimovies.com . 2K DCI has a screen resolution of 2048 x 1080 pixels.

[15] As presented, for example, at Screen International's Digital Cinema 2008 conference

[16] See, for example, the website of Emerging Pictures, which distributes Italian opera and independent films to digital screens around the world.

[17] According to the Italian authorities, the only Italian 2K digital release since 2001 has been Roberto Benigni's *Pinocchio* (2002), which had a reported production budget of €40 million . Prior to the publication of the DCI specifications in 2005, 2K referred to the HD format (1920 x 1080).

Commission also notes that the majority of films, particularly Italian and European films, were not released with 3D versions.

(83) Even allowing perhaps €5,000 for the computer storage, according to current commercial offers[18], a digital cinema installation with a high-end 2K 3-chip DLP digital projector which is suitable for intense use would currently cost €30,000 or less. An equivalent 1.3K installation would presumably be significantly cheaper and could perhaps be financed using a commercial model.

(84) Consequently, bearing in mind that the objective of the package of measures notified by the Italian authorities is to stimulate the distribution and release of Italian/European films, the Commission doubts whether €100,000 per screen is a fair estimate of the necessary costs of installing digital projection equipment. This therefore casts doubt on the necessity of the proposed digital cinema tax credit.

Proportionality

(85) The Italian authorities have provided box office data to support their view that the aid is proportionate to the specific market characteristics in Italy. These data confirm that Italian multiplex cinemas achieve higher average turnover per screen than single-screen cinemas. However, multiplexes also usually benefit from economies of scale in terms of lower average costs per screen.

(86) Consequently, this also implies that cinemas with a larger number of screens are more likely to be able to afford digital projection equipment without public support. Indeed, according to the Italian authorities, some of these multiplexes have already installed digital projection equipment without public support.

(87) At the same time, the Commission is aware that there are commercially-funded 'virtual print fee' models available to exhibitors. These are intended to share the costs of the digital projection with the distributors, which pay a 'virtual print fee' to the party which has financed the installation of the equipment each time that a digital film is shown on the equipment.

(88) The Commission is also aware of other commercial funding models for digital cinema, such as the model which has been applied successfully even to remote, rural cinemas in India[19].

(89) This raises the question of whether public support on the proposed scale per screen would 'crowd out' commercial alternatives, such as cost-sharing agreements between distributors and exhibitors. As a result, the Commission has doubts about the proportionality of the proposed digital cinema tax credit.

Adequacy

[18] See, for example, http://www.projectorpoint.co.uk/projectors/Panasonic_PT-D10000E.html

[19] http://www.televisionpoint.com/news2008/newsfullstory.php?id=1211980648

(90) The estimated budget for this measure is €16.8 million, which corresponds to installation costs of €56 million. However, as noted in paragraph (78), this would be considerably less than the overall investment of €395.7 million required to convert all screens in Italy implied by the estimated cost of €100,000 per screen. So, if the estimate of €100,000 per screen by the Italian authorities is reasonable, this would imply that the budget would only cover the costs of converting 14% of Italian cinema screens. Consequently, the Commission doubts whether the funding available for this measure would be adequate.

(91) While the Italian authorities suggest that their objective is to extend the use of digital projection to increase the circulation of cultural Italian and European films, it is not obvious how the proposed measure would be sufficiently targeted to achieve this objective. In particular, the main revenue benefits to cinemas from digital conversion appear to be derived from using the demand-driven programming which digital projection makes possible[20].

(92) However, the cultural conditions on larger multiplexes for receiving the aid could result in commercial films being screened using the newly-installed digital equipment while cultural films are shown only in 35mm form and at off peak times. This could place an additional financial burden on the distributors of such films, particularly during a transition period, since 35mm prints are more expensive than digital copies. The Commission therefore has doubts that the Italian authorities would be able to ensure that exhibitors which benefit from the aid would introduce the alternative commercial models which are possible with digital projection which would offer Italian cinema audiences a wider choice of cultural films.

(93) Since the aid takes the form of a tax credit, beneficiaries must be sufficiently profitable (or at least have sufficient tax liabilities) to make use of the tax credit for the aid to have an incentive effect. The Italian authorities have noted that 1-4-screen cinemas are struggling financially in the current climate, and that single screen cinemas are worst affected. They have also provided data showing that 74% of Italian cinemas are single-screen cinemas and 17% of Italian cinemas are 2-4-screen cinemas.

(94) Consequently, the Commission has doubts that the 91% of Italian cinemas (2,390 screens in 1,816 cinemas) which, according to the Italian authorities, would need the aid the most would be able to take advantage of a tax credit. Even when 1-4-screen cinemas have sufficient tax liabilities to be able to make use of the 30% tax credit, if they are struggling financially, it is unclear how they would fund the remaining 70% of the investment required. The Commission therefore doubts that 1-4-screen cinemas in Italy are likely to be able to justify a net initial investment of [70% x €100,000 =] €70,000 without a significant increase in revenue arising from the investment or in other sources of finance.

[20] See, for example, http://www.dodona.co.uk/experience.htm

(95) The notification concerns the first installation of digital projection equipment and is proposed as a pilot measure over a 2-year period. The Commission understands that, like other electronic equipment, the estimated useful life of digital projection equipment is between 5-10 years, after which its spare parts are likely to be obsolete. This is a much shorter useful life than that of the mechanical, 35mm projection equipment whose replacement this measure would encourage.

(96) The Commission also understands that the running costs of digital projection equipment are higher than those of 35mm projection equipment. The Italian authorities consider that the costs of installing digital projection equipment are beyond the normal budgets of Italian cinemas, particularly those with 1-4 screens. So, if the measure ends after 2 years, the Commission has doubts that this one-off support would provide a sustainable solution to the problem for all 1,816 such cinemas.

(97) In view of the above, the Commission has doubts about the necessity, proportionality and adequacy of the proposed Italian digital cinema tax credit.

Economic, social & cultural impact

(98) As mentioned in paragraph (94), 91% of Italian cinemas may not be able either to take advantage of a tax credit or to afford the necessary 70% initial investment and subsequent additional running costs. Under normal market conditions, businesses in such circumstances would face closure.

(99) The Education, Youth and Culture Committee of the European Council of Ministers noted in November 2008 that there was some urgency to find a common solution to financing the digital conversion of cinemas. The Commission had noted at the time that there was a risk that the process could jeopardise arthouse and local cinemas throughout Europe. The Presidency concluded that it was a major European challenge which could have an impact on maintaining cultural diversity.

(100) Against this background, the Commission is aware that it could be in the common interest for a Member State such as Italy to use State aid to invest in the transition to a new technology in such cinemas. However, the Commission would like to be assured by the Italian authorities that the proposed aid would be technologically neutral.

(101) In particular, the Commission would welcome confirmation from the Italian authorities that exhibitors would not be induced to invest in one digital standard in preference to another. In addition, the Italian authorities are invited to confirm that, as a condition of the support, exhibitors would have to ensure that films released in any digital format based on open standards which is lower than the digital standard of the supported equipment could also be screened.

(102) This would ensure that film producers and distributors could circulate their films to all aided cinemas in whichever digital standard they feel is the most

appropriate. It would also avoid distorting competition between digital standards and digital projection equipment suppliers both within Italy and, on a broader level, across Europe.

(103) The Commission understands that there is a general impression within the European film sector that the US film majors will only distribute their films digitally to DCI-compliant screens. The Commission is not aware of any evidence that the US film majors actually impose such a pre-condition on exhibitors. However, the Commission is aware that, in view of the potential savings from digital distribution, the US film majors currently offer to contribute to the costs of installing DCI-compliant projection equipment in commercial multiplexes throughout the EU. Consequently, the Commission notes that State aid for installing DCI-compliant projection equipment at least in commercial multiplexes could indirectly benefit the US film majors.

(104) The Commission also notes that the market for a digital standard limited exclusively to cinemas is likely to be niche, in view of the limited number of cinemas worldwide, with corresponding high costs and low annual production levels. Consequently, the Commission doubts whether the increased demand resulting from the proposed State aid for installing digital projection equipment could avoid raising the price of the limited supply of projection equipment intended specifically for cinemas, not only in Italy but throughout the EU.

(105) As with any technological change, film distributors are likely to switch to digital distribution when there is a critical mass of digital cinemas. While Italy could achieve this critical mass more quickly with the proposed aid, the Commission is concerned that the proposed aid may also accelerate the closure of those cinemas (most probably the smaller cinemas) which have not been able to install digital projection equipment by the time this critical mass is reached.

(106) The Commission therefore has doubts that the proposed Italian tax credits for digital cinema would avoid distorting competition to an extent which is compensated for by the social and cultural advantages of such State aid.

5. CONCLUSION

The Commission has accordingly decided that the notified measures constitute State aid within the meaning of Article 87 (1) EC but considers that all of the notified measures other than the digital cinema tax credits are compatible with the EC Treaty.

At the same time, in the light of the foregoing considerations, the Commission has doubts about the compatibility of digital cinema tax credits with the common market. Therefore, acting under the procedure laid down in Article 88(2) of the EC Treaty, the Commission requests Italy to submit its comments and to provide all such information as may help the Commission to assess this measure.

As your authorities have requested, in view of the number of interested parties involved and the complexity of the subject of digital cinema, and in view of the summer break, the formal submission of the Italian authorities concerning the proposed tax credits for digital cinema should reach the Commission by 31 October 2009. The Commission requests your authorities to forward a copy of this letter to the potential recipients of the aid immediately.

The Commission advises Italy that it will inform interested parties by publishing this letter and a summary of it in the Official Journal of the European Union. It will also inform interested parties in the EFTA countries which are signatories to the EEA Agreement, by publication of a notice in the EEA Supplement to the Official Journal of the European Union and will inform the EFTA Surveillance Authority by sending a copy of this letter. In view of the extended deadline granted to the Italian authorities and in view of the period of publication, all such interested parties will be invited to submit their comments within the same deadline: 31 October 2009.

If this letter contains confidential information which should not be disclosed to third parties, please inform the Commission within fifteen working days of the date of receipt. If the Commission does not receive a reasoned request by that deadline, you will be deemed to agree to the disclosure to third parties and to the publication of the full text of the letter in the authentic language on the Internet site: http://ec.europa.eu/community_law/state_aids/index.htm .

Your request should be sent by encrypted e-mail to stateaidgreffe@ec.europa.eu or, alternatively, by registered letter or fax to:

European Commission
Competition Directorate-General
State Aid Greffe
B-1049 Brussels
Fax No: +32 2 296 1242

Yours faithfully,

For the Commission

Neelie Kroes

Member of the Commission