

Robert Kenny & Tom Broughton

Securing the future of UK animation

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PERSPECTIVE

About Animation UK

Animation UK was formed in 2010 to represent the UK's animation industry. Its members include British animation companies and businesses working closely with them, ranging from the largest players in the industry to small specialists.

Animation UK campaigns for fairer trading conditions for UK animation producers, to help protect or increase the ownership of IP that is of such value to the UK Economy. It aims to work with the Government to get the best possible trading conditions for UK producers faced with increasingly subsidised competition from overseas.

About the authors

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Perspective Associates provide regulatory and policy advice to some of the leading media, entertainment and telecommunications clients in the UK and abroad.

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Foreword by Mark Field MP

My constituency is best known for containing in Westminster and the City respectively our nation's political and financial heart. But it is also spiritual home to a globally competitive creative sector in Soho and the West End that includes the film, music, television, theatre and animation industries. With our success in design, our expertise in information technology and our originality in film and theatre, creative industries arguably rank as the next most important overseas economic driving force after our financial services industry.

Indeed, after the tumultuous events of the past few years in the banking sector, creative industries offer one of the great white hopes for economic growth.

In terms of quality, humour and inventiveness, the British animation industry in particular is second to none. Past success in this field has been such that characters like Aardman's Wallace and Gromit have become part of our national heritage. They are also adored worldwide, acting as ambassadors that embody the spirit of our nation.

But many of our family favourites have moved abroad to be animated by foreign production companies. Why? Cheaper overseas labour provides part of the answer. But bigger than that have been the huge funding incentives in terms of tax breaks and creative funds in other countries that make it nearly impossible for UK companies to compete. Now nearly every nation in the world with an animation industry is offering government-backed incentives to attract animation work.

Put simply, there is no level playing field. Price and product have become secondary to cashflow. The corollary is that animators can waste years putting together funding packages in the UK before often having to resort to co-production with a business operating outside the country, losing a significant proportion of IP rights in the process.

Combine that with a massive reduction in children's broadcasting and a drop in the prices for programming because of the junk food advertising ban, and we are left to rely solely on the UK's edge in talent to keep the animation industry afloat.

Yet if we allow this industry to be eroded, we could face an exodus of opportunity from our shores. Skilled young talent may be driven abroad; we could lose the chance to exploit highly lucrative ancillary licensed products; we may see the leaching of expertise, creating a skills dearth in complementary industries such as post-production; and we risk undermining our cultural heritage. Indeed it is precisely because of the vast opportunities that flow from a thriving animation sector that other nations are so keen to attract the business.

The government has a unique opportunity to support the animation industry at this critical juncture in its history. I have been working with dynamic industry players on this issue for over two years now, and have been consistently taken aback by their passion and drive. In producing this comprehensive report, Animation UK has provided us with a physical expression of that passion and proved via a conservative estimate that assistance in this area could lead to a net gain for HM Treasury.

Our animators have never wanted handouts. They are confident that they have the skill, flair and ideas to attract work. Nor do they argue against the free market. The problem lies in the fact that at the moment the market is far from free.

The government has been consistent in espousing its support for the creative industries. Here is an opportunity to turn a sympathetic ear into a lasting difference for British animators. Their case now deserves a thorough hearing.

Mark Field MP, Cities of London & Westminster

Executive Summary

The UK TV animation industry has a long track record of creative and commercial success. Iconic programmes - such as *Wallace and Gromit*, *Bob the Builder*, *Noddy*, *Peppa Pig*, and *Thomas and Friends*¹ – were devised, developed and animated in the UK. They have been exported around the world, showcasing the best of the UK's creativity, allowing British companies to tap into the wide range of secondary and ancillary revenue streams, and providing a platform from which money has been reinvested into new content. The sector continues to create characters that will be the global brands of tomorrow.

Although the UK animation sector is relatively small (we believe it has revenues of around £300m), it is an important part of the creative industries and its impact and influence are widely felt. It:

- ***Supports a range of other industries.*** CGI provides the visual effects for the £1.4bn UK post production industry, and animation skills are crucial for the UK's gaming sector, which directly employs 9,000 people and generates £1bn of GDP
- ***Stimulates downstream retail markets.*** A programme with a production budget of just a couple of million pounds can generate many multiples of this through the sale of ancillary licensed products such as children's DVDs (worth £140m in the UK), books (£473m) and toys (£730m).
- ***Provides an important source of cultural identity.*** Children's TV (including animation) shapes children's view of the world. Amongst UK parents, 70% say that UK-produced programmes contributed to the UK's cultural identity. Animation has also helped to take the UK to the world, showcasing Britain and British sensibilities. *Thomas and Friends* is the number one Western pre-school toy in China, Japan and Korea.

But a unique set of challenges face animation in the UK, setting it apart from other audiovisual production industries.

TV animation is a highly international business, much more so than most other sectors of television, and possibly even more so than film. This is not in itself a problem, rather it should be (and is) an export opportunity given the UK's animation skills. However, in an increasing number of countries animation is receiving substantial government support. In other more domestically-oriented sectors this might not matter, but for animation it is putting severe (artificial) competitive pressure on UK businesses, making it far harder to justify production in the UK. Of the iconic programmes mentioned above, three out of five (*Noddy*, *Bob the Builder*

¹ Based on *Thomas the Tank Engine*

and *Thomas & Friends*) are no longer animated in the UK, and increasingly, British animation companies must co-produce with foreign partners to access the benefits of overseas government support.

This problem has been exacerbated by some domestic policy changes in the UK, such as the ban on fast food advertising in children's TV, and the constraints on the BBC's programming budget. These have resulted in a reduction in the children's TV slots on the main channels and put pressure on UK broadcaster spend on animation.

As a consequence:

- *Domestic animation production is falling*, with an associated loss of jobs
- *Rights to future revenue streams are having to be shared with co-production partners*, diminishing long term value to UK companies and creating a 'vicious circle' of decreased funding and investment
- *Skills and expertise are being transferred overseas*, eroding the UK's position of competitive strength; amongst independent animators, 76% told us that they were currently or had considered moving overseas for work

Absent government action, UK animation may soon simply cease to be viable. But despite the challenges it faces, we believe that UK animation can not only survive but thrive, with appropriate government support. This could include a tax credit similar to the R&D or film tax credit, an investment fund or quotas. A tax credit would be at least revenue neutral for the Exchequer, given the incremental pay roll taxes, VAT and corporation taxes generated by an animation sector able to compete on a level playing field with its international rivals.

The potential benefits of government investment in animation are material, since:

- *The UK is already starting from a position of strength*. Many of the UK's animation studios offer internationally renowned expertise in a wide range of specialisms
- *The opportunity to become a global leader remains*. The UK production sector has the chance to establish global centres of excellence, and become a genuine world leader in certain areas of production, including 3D production, CGI and visual effects
- *The global market continues to grow*, driven by infrastructure change, new technologies and consumer appetite for animated content
- *There is huge potential for rights exploitation - if the UK can hold onto its IP*. The global TV brand licensing industry was worth £115bn in 2009. In the UK alone, *Peppa Pig* generates 150 times its original production budget in retail revenues each year (£200m) and could become a "\$1bn franchise"

- *Animation is consistent with the UK's ambitions for growth.* It is knowledge intense, IP generating, builds on material existing competitive strengths and has significant export potential

A note on scope

The prime focus of this report is TV animation (both for children and adults) and its many ancillary products and services – everything from character websites to plush toys.

Film animation uses the same skills, and is often made by the same companies. However, it is a small part of total animation (we estimate less than 10%), and also already receives support in the UK via the Film Tax Credit.

Animation for TV commercials, games and so on is also not part of the scope of this report. The economic issues for these are very different, and again they are a relatively small part of UK animation – perhaps 10-15%.

That said, given the breadth of scope of some providers and some of the common skills, support provided to TV animation will also benefit these other sectors.

I. Introduction

The UK's animation industry has been a creative, cultural and economic success story. Iconic programmes - such as *Wallace and Gromit*, *Bob the Builder*, *Noddy*, *Peppa Pig*, and *Thomas and Friends* – were originally devised, developed and animated in the UK and exported around the world, showcasing both the UK's talent and sensibilities.

In this report, commissioned by Animation UK, we discuss the challenges the sector faces, and why it is still important for the UK.

We begin by outlining the UK's animation industry today, highlighting the unique characteristics that distinguishes it from other forms of audiovisual content production.

We discuss the economic and cultural importance of animation to the UK in sections 3 and 4 respectively.

In section 5 we outline the substantial opportunities for the UK animation industry, and then turn in section 6 to the challenges for the industry.

We then focus in on the government support offered elsewhere (section 7), and the adverse impact this is having on UK animation (section 8). This leads us to the prospects for UK animation absent of government support (section 9).

Next we discuss some of the forms of intervention that could realistically support this sector (section 10), and the financial trade-offs for the Exchequer (section 11).

In section 12 we offer our conclusions.

In researching these issues, we have gathered the (limited) existing data on UK animation, interviewed a number of industry stakeholders including production companies, distributors and commissioners, and undertaken our own industry survey.

Rob Kenny and Tom Broughton, 2011

The UK and the origins of animation

Animation is based on the phenomenon of 'persistence of vision', first identified in a paper by Peter Mark Roget published in 1825 by the Royal Society in London. In 1899 what many consider to be the first animation in film was made by Arthur Melbourne-Cooper of St Albans for the Bryant May match company. In 'Matches Appeal' stop frame puppets made of matches were filmed frame by frame as they wrote on a blackboard, six or seven years ahead of the animation pioneers in France and America.

2. The business of animation

Key points

- TV animation is a very different business from other forms of TV content
- Some UK business both create characters and stories and produce animation, others purely produce, and a small number focus on the characters and their marketing, leaving production to others
- Production budgets are drawn from many sources, including broadcasters (domestic and overseas), co-production partners, merchandisers, investors and (outside the UK) governments
- Ancillary revenues from DVD sales, merchandise and the like, is highly important for animation

Animation is very different from other types of TV content, not just in its craft but also in its distinct funding sources and business model.

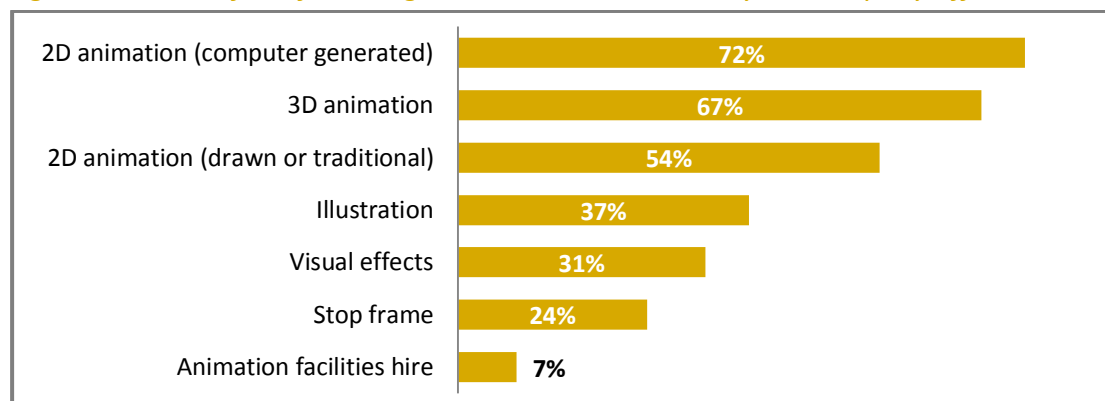
Animation products and services

The UK's animation sector has four main disciplines:

- **2D drawn animation**, the traditional process of animation whereby individual frames are first drawn on paper, with each drawing differing slightly from the next
- **Stop frame animation**, an animation technique used to make a physically manipulated object appear to move on their own by moving them in small increments between individually photographed frames
- **2D computer generated animation**, whereby animated figures are created and edited on a computer using 2D computer graphic software
- **3D computer generated animation**, whereby characters are digitally modelled using 3D computer software, often around a mesh or digital skeletal structure

Amongst animation production companies, most offer a range of services. Our survey of 81 animation companies found that 2D and 3D computer generated animation were the most frequently offered, with traditional hand-drawn 2D animation still provided by over half of respondents.

Figure 1: Which of the following animation services does your company offer?²



In the UK, work for TV is, by some margin, the most important source of revenue. Many animation companies also produce corporate and music videos, commercials, games and other interactive media, but in aggregate these revenues are comparatively small. A smaller group of companies make animated films. While important for these particular companies, animated films are again a small part of the industry as a whole.

Animation companies tend to be small (an average of less than 8 employees per company based on the Skillset numbers) and are distributed across the UK (according to Skillset, 70% of the animation industry is based outside London³).

Business models

The animation sector varies not just in the techniques they use, but also in their commercial approach. Most fall into three main types of business model:

1. Companies who own the rights to characters, and do their own pre-production (scripts, character bibles etc) but tend to partner with others for production (HIT Entertainment, Entertainment One in the UK)
2. Companies who develop characters and do their own pre-production and production (Aardman Animation, Blue-Zoo, Baby Cow, etc.)
3. Smaller business who undertake specific animation projects on a 'work for hire' basis, including corporate videos, websites and subcontracting of elements of TV productions e.g. titles and stings (in the UK such companies do not generally produce entire TV programmes)

Companies may focus exclusively on animated content, or be more generalist production companies who produce animation as well as live action.

² Perspective Associates survey of UK animation companies

³ Skillset Animation Sector Profile 2008

Securing production budgets

The funding of animation differs significantly from other forms of television production. With most television content, broadcasters will tend to put forward the bulk of funding in exchange for the broadcast rights (which, for UK public service broadcasters, is defined by the Terms of Trade).

However, with animation a commission from a domestic broadcaster is necessary but not sufficient, with broadcasters only putting up a small proportion of the project cost. As a consequence, animators need to seek production funding from a much wider range of sources. The full range of sources often includes:

- *Domestic broadcasters.* In contrast to most television content, licence fees for animation tend to be less than a quarter of the production costs. For example, the BBC typically only provides 10% - 24% of the production budget⁴
- *Pre-sales to overseas broadcasters.* Additional funding is often secured through pre-sales to one or more international broadcasters (typically the production company is prohibited from selling to further domestic broadcasters under the terms of their commission or acquisition agreement)
- *Co-productions.* An animated programme will often be produced jointly by two or more production companies in different countries. This allows financial resources to be pooled and, crucially, can give producers access to government incentives and subsidies in other countries. (Co-production is discussed in more detail in section 8)
- *Distribution advances.* Distributors can provide an advance based on a forecast for secondary revenues for an animated programme, most notably the sale of the finished programme to international broadcasters. In return for the advance, the distributor will then take a percentage of the sales revenues.
- *Advances on ancillary revenues.* By selling licences to master toy companies, publishers and DVD companies, animators can lock in 'minimum guarantees', securing an income stream (and sometimes an upfront payment). Royalty rates for toys, books, comics and other merchandise are typically 10% – 15%. DVD royalties can be higher at 15-25%, but as DVD sales have declined, advances and guarantees have become harder to secure.
- *Loans from banks or deficit / gap finance.* Animation production companies may also seek funding from finance providers, such as banks or specialist financiers such as Ingenious Media or Octopus Investments. Banks are often

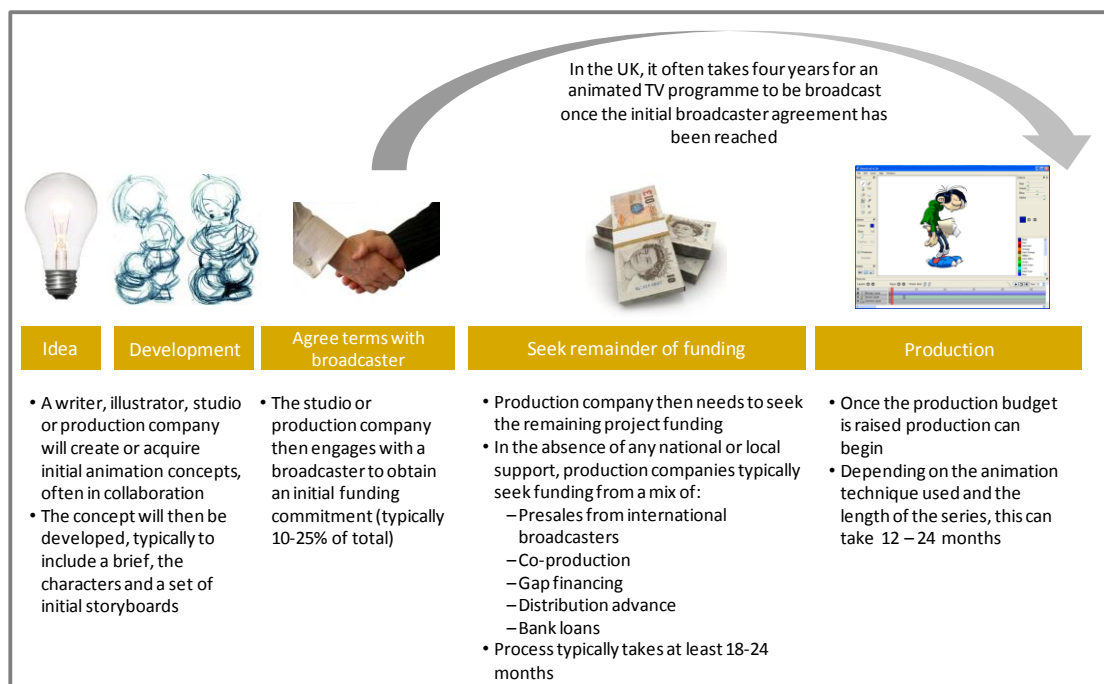
⁴ Industry interviews. Note that if a broadcaster's share is more than 24%, then they become a commissioner rather than an acquirer, and under the terms of trade are entitled to 15% of global net profits

cautious about lending against business plans even where forecasts are by recognised distributors. In some cases loans are secured on pre-sale commitments or distribution advances.

- *Loans from directors, friends and family.* Director, producers and friends or family will sometimes put their own money into a project in cases where a deficit still exists.
- *Government subsidy and regional / national funding agencies.* Government subsidies, tax breaks and regional funding agencies are, outside the UK, a critical source of funding for animators, often funding 25%-50% or even more of the total cost of production. (See section 7 for a detailed discussion)

Securing the production budget from this wide range of sources, often spread around the world, is costly and time consuming. The process usually takes around two years and some cases up to four or even five.

Figure 2: An animation production timeline in the UK: concept to production



Given the complexity and time-consuming nature of the funding process, there is an ever present risk that it will fall through. Indeed, our discussions with production companies and commissioners suggested this is surprisingly common.

Ancillary revenues

The key to significant financial success for an animation project is (generally) the ancillary revenues that a popular show can generate once broadcast (and once minimum guarantees have been covered). DVDs, toys and other merchandise can drive licensing fees far beyond that seen for live action programming. HIT

Entertainment, for example, generates almost 90% of its revenues from home entertainment and consumer products.⁵

Animation and risk

The production of animation involves a substantial amount of risk, not only because it is an inherently uncertain creative process, but because costs of programming are payable when incurred, while revenues from programming are received at a later date (and depend in part on the ultimate success of the programming). As noted, upside derives largely from ancillary revenues, which depend on the popularity of the programme.

Optima suggest that even successful UK originated productions may not be cash positive for seven years⁶, though five years might be more typical.

⁵ Company accounts for Sunshine Holdings 3 Limited, year ending July 2010

⁶ Optima, *The Likely Costs and Benefits of a UK Animation Fund*, 2004

3. The economic importance of UK animation

Key points

- UK animators have revenues of around £300m and employ a highly skilled workforce of 4,700
- The TV animation industry has strong links with other key sectors of the creative economy, including post production, gaming
- Animated brands also drive downstream markets such as DVDs, toys and books

We now turn to the economic importance of UK animation. In of itself, the sector is only of moderate size. However, it has substantial spill-overs to other sectors of the creative and retail economy.

A small but important direct impact

According to Skillset, in 2008 there were over 600 companies directly involved in animation in the UK, employing around 4,700 people^{7 8}.

Unlike some other sectors in the creative media industries, the impact of animation is felt across the UK. There are a number of distinct and highly successful centres of excellence outside London, including Bristol, Manchester and Dundee. According to Skillset, 70% of the animation industry is based outside London⁹.

With revenues of around £300m¹⁰ the animation industry in the UK is comparatively small. However for the reasons we discuss below, its impact and influence are felt much more widely.

Supporting a wide range of other industries

The core UK animation industry has synergies with a wide range of other creative industries and provides important spillovers from technical developments, most notably CGI, visual effects and 3D.

⁷ Skillset Animation Sector Profile 2008

⁸ However our own analysis suggests that the current figure may be considerably less (possibly as much as 28% lower) due to the challenges we discuss later in this report

⁹ Skillset Animation Sector Profile 2008

¹⁰ Note that this figure does not include revenue associated with animation from larger production companies with animation production capabilities (e.g. Tiger Aspect), visual effects companies and other animation support services (supplies, studio hire, etc). The total revenue of the four largest animation companies in 2009 - HIT, Aardman Animation, Chapman and Chorion - was £246.7m (Companies House)

The skills used in animation are inherently transferable to a range of other industries. TV animators frequently also work on commercials, music videos, websites, corporate videos and computer games. Particular areas of support include:

- **Post production.** Animation, particularly CGI, contributes to the visual effects for the £1.4bn UK post production industry¹¹. The UK has won contracts for almost all of the major recent US-made visual effects blockbusters – such as *Avatar*, 2012 and *Cloverfield*.
- **Gaming.** Animation skills are crucial for the UK's gaming sector, which directly employs 9,000 people, generating £1bn¹² of GDP and £488m of annual exports¹³. 41% of UK games developers outsource some animation, highlighting the contribution of independent animators to the gaming sector¹⁴.

The industry also supports a wide range of other skilled professions including musicians, set designers, narrators, puppeteers and cameramen.

Stimulates downstream retail markets

Animated TV content has the potential to create huge value in downstream retail markets. In 2010 *Peppa Pig*'s UK licensing and merchandise sales were £200m¹⁵, the *Thomas & Friends* franchise is worth a similar amount¹⁶ and *Fifi and the Flowertots* has generated retail sales of 17m units¹⁷.

A programme with a production budget of just a couple of million pounds can generate many multiples of this through the sale of ancillary products such as DVDs, books and toys. The rights holders will often receive 10%-25% of the gross revenue of ancillary products, with the wider economy benefiting through retail expenditure (and VAT collection).

Ancillary markets are large and are often driven directly by character-based content. For example:

- In 2009, 234.6m DVDs were sold in the UK worth over £2bn¹⁸. Of these, children's DVD represented 6.9% of sales by value, and 11.1% by volume¹⁹.

¹¹ Skillset, The Animation Sector Profile, 2008

¹² Budget for Growth: Powering the Video Games Sector to Support the Economic Recovery, Tiga, 2011

¹³ Screen Digest / E.L.S.P.A.

¹⁴ TIGA, Download April 2009, http://www.tiga.org/Documents/Download05_FINAL.PDF

¹⁵ See <http://www.londonstockexchange.com/exchange/news/market-news/market-news-detail.html?announcementId=10770600>

¹⁶ See <http://www.ft.com/intl/cms/s/0/8d64a042-28bc-11e0-aa18-00144feab49a.html#axzz1TOdnclyZ>

¹⁷ See <http://www.chapmanentertainment.co.uk/#/fifi/>

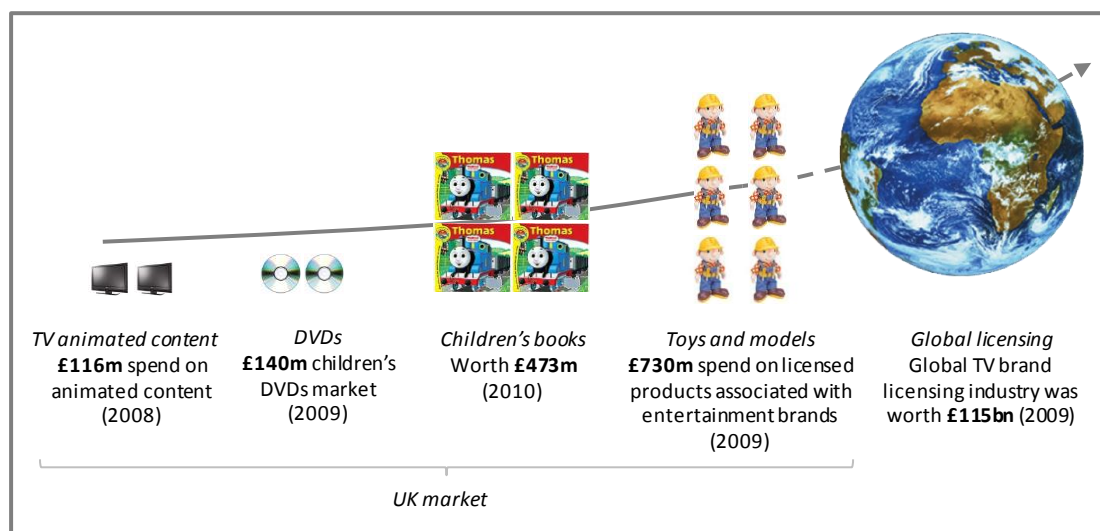
¹⁸ http://www.bva.org.uk/files/images/BVA_Yearbook_2009_members_fullbook.pdf

¹⁹ ERA Yearbook 2010

- The value of the children's UK book market in 2010 was £473m, representing 14% of the total UK market²⁰.
- In the UK in 2009, just over a quarter of all sales of toys and models (£730m out of a total £2.7bn) involved products made under licence to a marketed entertainment product, such as animated children's TV shows²¹. The sale of toys continues to be a growing market; pre-school toys grew 9% to £350m last year according to the NPD.

In addition, the global TV licensing market is huge (worth around £115bn in 2009) and growing. For example, globally toy sales grew by 4.7% in 2010 to US\$83.3 billion, driven in part by high demand from Asia (which saw 9.2% growth)²².

Figure 3: Illustration of the potential downstream value created by animated TV programmes²³



A highly skilled workforce

The UK animation industry is comprised of young, dynamic and highly skilled workers. 50% of the industry is under 35, and over 90% hold a graduate qualification²⁴.

²⁰ <http://www.thebookseller.com/news/kids-sales-fall-third-year-row.html>

²¹ <http://www.thebookseller.com/news/kids-sales-fall-third-year-row.html>

²² NPD retail tracking group, referenced in Oxford Economics, *The Economic Impact of the UK Film Industry*, June 2010, <http://www.oxfordeconomics.com/samples/oefilmindustryjune10.pdf>

²³ Global Toy Market Estimates: 2011 Edition

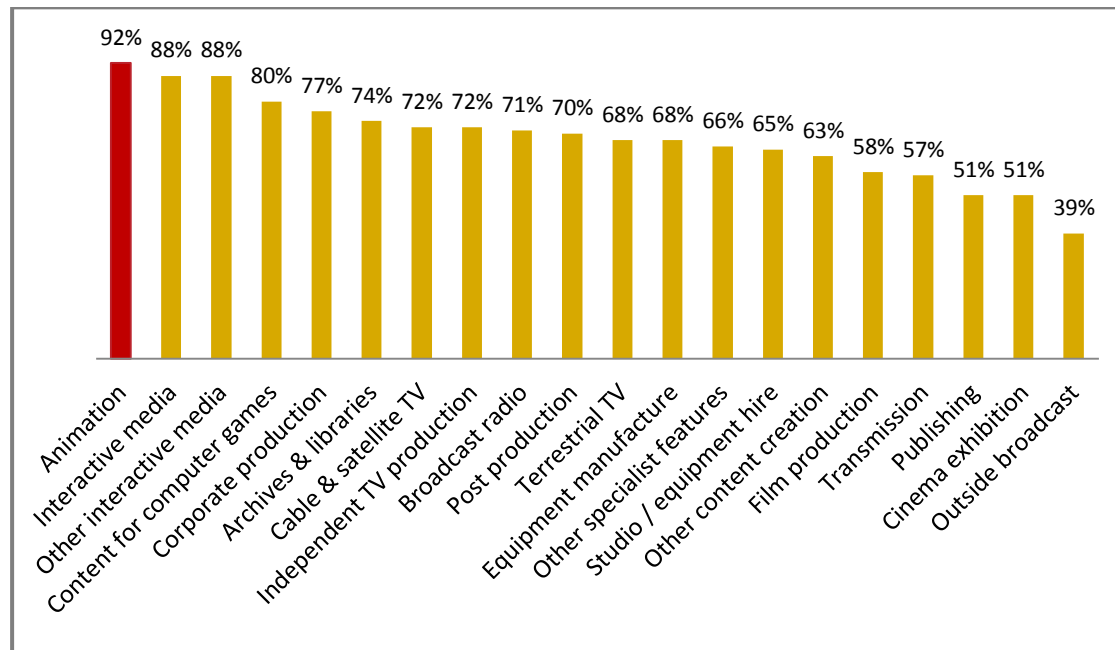
²⁴ Sources: Screen Digest 2008, Official Charts Company, ERA yearbook, The Book Seller, NPD retail tracking group

²⁵ Skillset Animation Sector Profile 2008

The industry is well supported by 53 animation degree courses in the UK, which accommodate 2,269 students, supplemented by a further 233 higher education courses²⁵.

People working in the animation industry not only have a much higher level of qualification than the population at large, but also higher than the rest of the creative industry.

Figure 4: Proportion of employees with graduation qualification by creative industry²⁶



Animators also tend to be highly flexible, frequently moving between companies and contracts. Nearly two fifths of those involved in animation are freelance or on short term contracts, and almost 20% sole traders or self-employed²⁷.

They are also technologically skilled, producing internationally revered CGI and 3D animation using the latest software (which is often also developed in the UK). Many animation companies also produce web and mobile content since the skills possessed by animators lend themselves highly to digital and online environments.

²⁵ UCAS

²⁶ Skillset, The Animation Sector Profile, 2008

²⁷ Skillset, The Animation Sector Profile, 2008

4. The cultural importance of UK animation

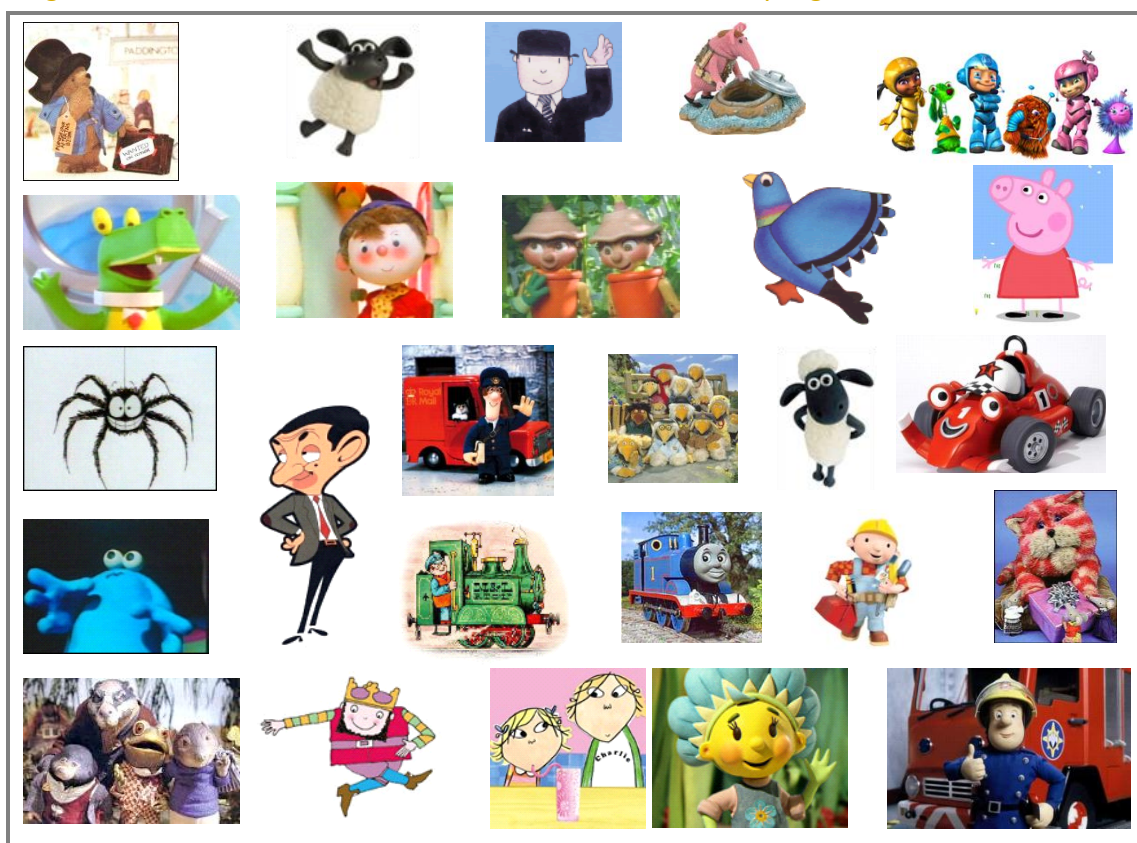
Key points

- UK animation is a key component of children's TV, and meets a need for culturally relevant programming for children and their parents
- As successful exporters, UK animators also take a UK perspective and sensibilities to the world

Beyond its purely economic significance, animation has great cultural importance. Children's audiovisual content, of which animation is an integral part, permeates all children's lives, and each of us remembers the iconic TV characters of our childhood.

PACT research found that 70% of parents agreed that UK-produced programmes contributed to the UK's cultural identity²⁸. Parents say animation provides "valuable relaxation and lighthearted viewing that fuel[s] children's imagination".²⁹

Figure 5: UK animation and children's TV: characters and programmes



²⁸ <http://stakeholders.ofcom.org.uk/binaries/consultations/kidstv/responses/pact.pdf>

²⁹ Ofcom, *Ofcom Research Report: The future of children's programming*,

While animation travels more readily across borders than some other genres, this does not mean it does not reflect national sensibilities – compare *Danger Mouse*, *Wallace and Gromit* and *Charlie and Lola* to *Teenage Mutant Ninja Turtles*, *Masters of the Universe* and *Dora the Explorer*. Children (particularly pre-schoolers) in the UK are far more likely to have television reflecting the culture of the UK if animation is still made here.

Even co-productions involve a level of cultural dilution. As a French animator reported:

“a company from Turkey wanted to co-produce Babar with us, but they wanted us to add some weapons into the cartoon, because children in Turkey do not watch shows unless there are fights.”

While UK-made animation can deliver animation reflective of UK sensibilities to children here, it also does so overseas. Programmes such as *Postman Pat* and *Shaun the Sheep* have been sold around the world, promoting quintessentially British sensibilities. *Thomas and Friends* is the number one Western pre-school toy brand in China, Japan and Korea, and the number 1 preschool toy in the US for the 10th consecutive year.

We also note that TV has grown in importance as a source of learning and education. In a digitally enabled world, animated content is likely to play a growing role in educating children in engaging and collaborative ways. As the success of puzzle based children’s online gaming site Moshi Monsters suggests³⁰, animated content is likely to play an important culture role in future generations’ learning and interaction.

³⁰ Developed by UK based company Mind Candy, Moshi Monsters is the fastest-growing children's gaming site in the world, with more than 50 million children signed up worldwide including 13 million British 6-12 year olds, despite being only 3 years old

5. The opportunity for UK animation

Key points

- The UK's animation heritage and skills are a powerful platform to build on
- The UK's share of the growing global animation market is under 15%, giving the opportunity for substantial expansion
- Beyond sales of programmes, the exploitation of rights via merchandise is also a substantial opportunity
- As a knowledge intense, IP generating industry with export potential, animation is a perfect fit for the UK's growth ambitions

As we will see in subsequent chapters, UK animation faces some material challenges. However, it also has substantial opportunities. The global animation market is large and fluid, and the UK has some real strengths to build on. This creates the potential for appreciable 'share capture' should UK animation be on a level playing field.

Starting from a position of strength

UK animation has long been a successful producer of intellectual property. *Bob the Builder* is 13 years old, *Postman Pat* is 30 and *Noddy* (in animated form) is 35.

Many of the UK's animation studios offer internationally renowned expertise in a wide range of specialisms. The UK is acclaimed for its pre-school storytelling, producing such TV hits as *Charlie and Lola* (Tiger Aspect Productions). The UK also has an international reputation for its expertise in short film and stop frame animation. *Wallace and Gromit*, for example, have won a string of Oscars.

Indeed, emerging economies continue to look towards the UK for guidance and expertise. According to Sun Lijun, Dean of the School of Animation at the Beijing Film Academy, in December 2010:

*"China needs more skilled innovators to help the country make progress in the animation industry. Compared to the UK, which is regarded as one of the world leading animation producers, China still has room for improvement"*³¹

Given the UK's strong heritage in animation and proven track record at commercially exploiting animated TV content, it remains in a position of strength despite growing international competition. Tom van Waveran, CEO and creative director of distributor Cake Entertainment, has said:

³¹ See <http://arts.culturalsources.com/arts-contemporary-60140.html>

“In some ways the Asian market is the exact opposite of the UK in that it doesn’t really have the expertise to develop IP in the way the UK can”³²

The opportunity to become a world leader

The UK production sector has the chance to develop global centres of excellence, as a genuine world leader in certain areas of production. UK animation companies have often been the first to adopt pioneering techniques and technologies.

For example the UK is now among the world leaders in developing 3D content for broadcast to the home. A number of production and post-production houses have already worked with Sky to produce 3D content, using a complex array of computer animation and visual effects. The experience gained will be transferrable to projects around the world as demand for 3D content grows. NaturalMotion, developed dynamic motion synthesis (DMS), widely regarded as a breakthrough in 3D character animation³³.

The UK is also a world leader in producing computer-generated animation for computer and video games. Major examples include Tomb Raider’s *Lara Croft* character, designed by Briton Toby Gard.

The UK is already the world leader in the production of visual effects for TV and commercials, and only the US and New Zealand are ahead of the UK in terms of the value of visual effects produced for feature films³⁴. Examples include Double Negative, whose extensive portfolio includes the *Harry Potter* film series.

Global opportunities for growth

Within the major Western markets³⁵, the UK’s share of TV animation produced (in value terms) is around 15%³⁶. However, the need to co-produce and subsequent loss of exploitation rights mean that the UK’s share of secondary and ancillary markets is considerably lower. The UK therefore has a small share of what is a large global animation industry. In other words, the opportunities for growth are significant.

This is also a growing market. Animation is an increasingly pervasive form of audiovisual content, used across television, film, commercials, games, shorts, music videos and the internet. This is likely to continue for a range of reasons, including:

³² Televisual, July 2011

³³ Creative Industries UK brochure

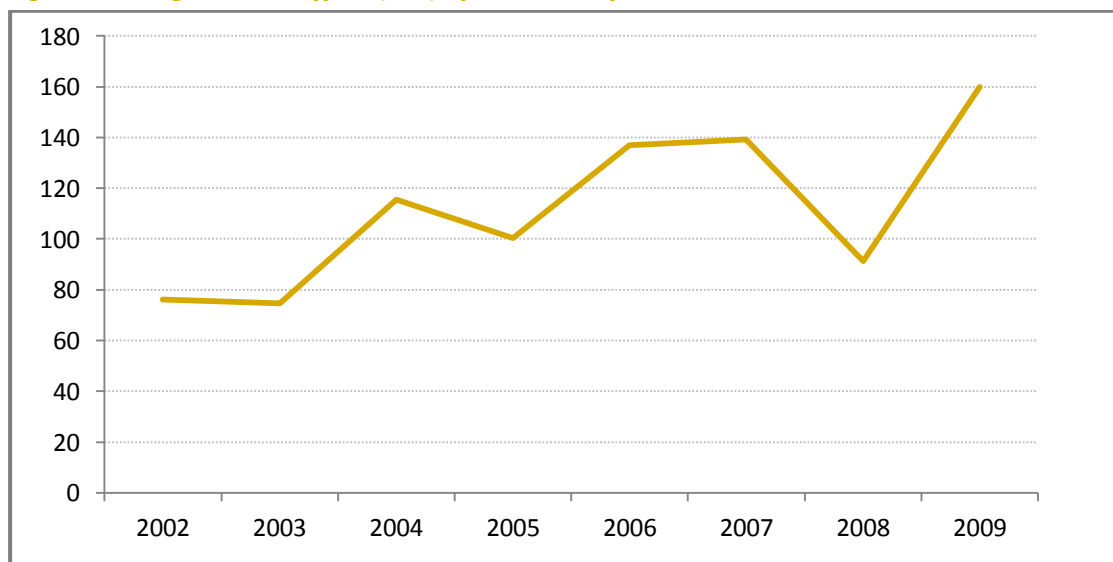
³⁴ Post Production in the UK, a report by Salix management consultants for the UK Film Council and the DTi, 2003

³⁵ Australia, France, Germany, Italy, Spain, Canada and the US

³⁶ Screen Digest, The Global Animation Industry

- **Infrastructure change.** Increasing television penetration around the world, a move to multi-channel TV and more flexible scheduling by broadcasters creates opportunities for animators. This has fuelled the development of children's and other thematic channels that rely heavily on animated output.
- **New technologies.** The emergence of new platforms such as IPTV and connected TV, and smartphones supported by faster distribution networks, provides new, on-demand ways to access animated content.
- **Appetite for adult-orientated animated content.** Traditionally perceived as a children's-only genre in most western markets, animation has continued to gain adult audiences around the world. Vastly successful programmes like *The Simpsons*, *South Park* and *Family Guy*, and serious, award winning animated films such as *Waltz with Bashir* and *Persepolis*, illustrate this trend.
- **Growth in animated feature films.** Big-budget features such as *Toy Story* have enjoyed great commercial success and 2002 saw the introduction of the first ever Oscar for an animated feature, won by Dreamwork's *Shrek*. In June 2011, DreamWorks Animation's *Kung Fu Panda 2* generated the highest opening weekend of all time in China, taking 125m yuan (£11m). In the UK, box office revenue of animated films has grown by over 110% from 2002 to 2009 (compared to headline growth of 39%).

Figure 6: UK gross box office (£m) of animated films, 2002 – 2009³⁷



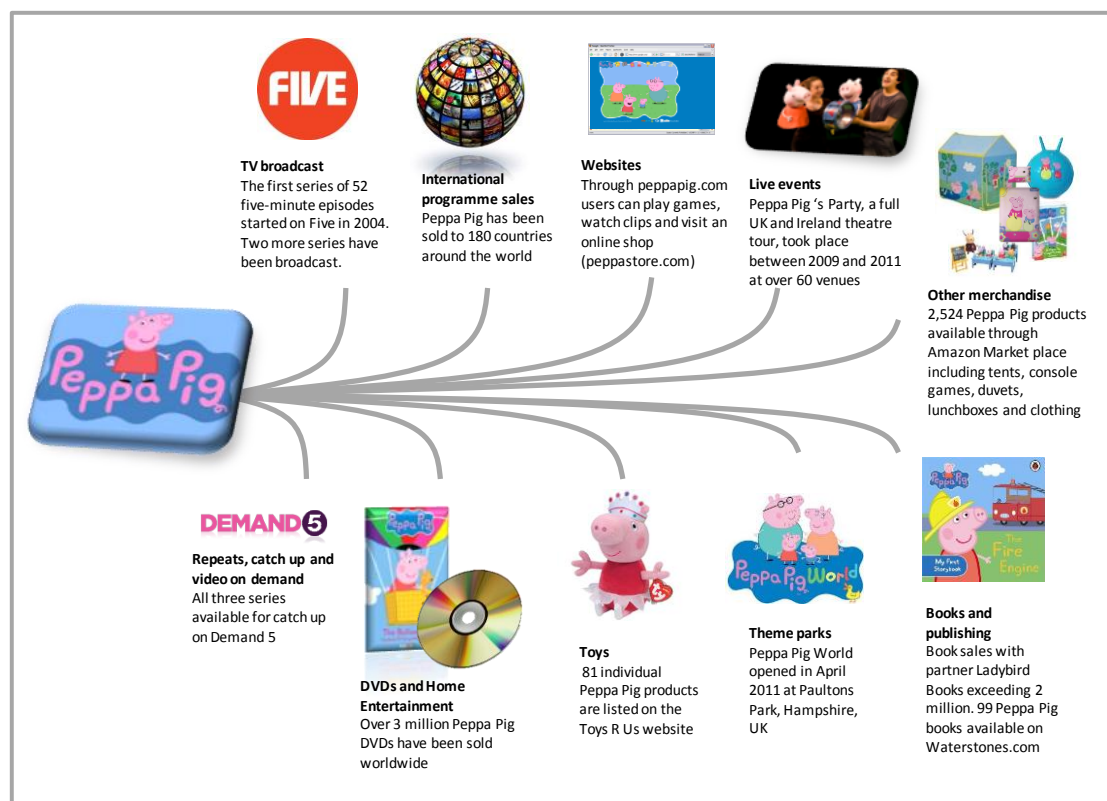
³⁷ UK Film Council, Perspective Associates analysis

Huge potential for rights exploitation

The global TV brand licensing industry is enormous (in 2009 it was estimated to be worth \$191bn, or £115bn) and the characteristics of animation mean it is well placed to exploit this opportunity. Indeed, the most successful television brand of all time, *The Simpsons*, is an animated programme with global DVD and merchandising sales of more than \$8bn (£5.1bn).³⁸

Closer to home, *Peppa Pig*, the British animated television series created, directed and produced by Astley Baker Davies, generates £200m in UK sales of licensed products each year. This is 150 times its original production budget, and indeed more than the total amount spent on all animated TV content in the UK. First broadcast in 2004 on Channel 5, it is now a global phenomenon. *Peppa Pig* is watched in 180 countries, with DVD sales of over five million,³⁹ a video game selling 225,000 copies and book sales exceeding 2 million. A recent deal with Fisher-Price means that the *Peppa Pig* franchise could “become a \$1bn brand”⁴⁰.

Figure 7: Illustration of the global value of the Peppa Pig franchise



³⁸ See <http://www.guardian.co.uk/media/2010/sep/22/the-simpsons-merchandising>

³⁹ Licensing.biz, Five million unit DVD milestone reached by Peppa Pig, 1 August 2011, <http://www.licensing.biz/news/7632/Five-million-unit-DVD-milestone-reached-by-Peppa-Pig>

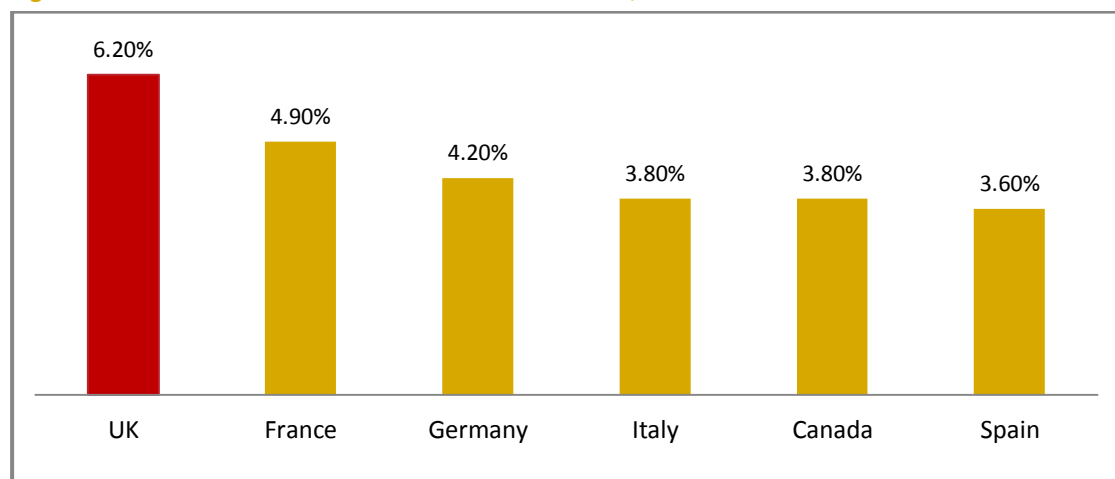
⁴⁰ See <http://www.guardian.co.uk/tv-and-radio/2011/may/31/peppa-pig-fisher-price-deal>

However, though it has enjoyed enormous success, *Peppa Pig* almost never happened. Astley Baker Davies was unable to secure the initial budget of £1.3m budget from commercial sources, and had to raise £350,000 from friends and family.⁴¹ Without this the programme may never have been commissioned, or significant chunks of the IP rights may have needed to be sacrificed. Indeed, whether *Peppa Pig* would be produced in this country today, given the scale of the challenge now facing UK animation production, is uncertain.

Consistent with the UK's ambitions for growth

The animation industry is an important part of the UK's strong creative economy, which itself responsible for over 2m jobs and contributing 6.2% of GDP, higher than almost all other countries. Animation is important not just in the sense that its own revenues and employment add to the UK total, but also as a cog in the wider engine that is Creative UK plc. It contributes to gaming, to films, to advertising and so on.

Figure 8: Creative industries contribution to GDP, UK versus other countries⁴²



As Creative Industries Minister Ed Vaizey has noted:

*“The creative industries are a key part of our economy and we must ensure the Government helps this sector grow”*⁴³

At the first meeting of the Creative Industries Council in July 2011, Vince Cable emphasised the enduring importance of the creative industries to the UK:

*“The UK leads the world in creative talent, representing ...a large and rapidly growing share of our exports. We have the largest creative sector in Europe. But we can't take that for granted”*⁴⁴

⁴¹ See <http://www.ft.com/cms/s/2/b7bcd9b6-9ab1-11df-87e6-00144feab49a.html#axzz1TxYPbfCg>

⁴² TERA (2008), *Valuing Culture, Measuring and Understanding Canada's Creative Economy* (2008). Note that the economic contribution refers to the core or direct impact and does not include indirect or induced effects.

⁴³ http://www.culture.gov.uk/news/news_stories/8294.aspx

As Britain moves away from a manufacturing economy, the creative industries will become an increasingly important source of competitive advantage. As Jonathan Kestenbaum, then chief executive of NESTA noted in 2006:

“As globalisation drives down the costs of manufacture, it is in the industries where creativity and tacit knowledge are at a premium that the value-add for UK plc lies”⁴⁵

In a 2007 debate, Baroness Bonham-Carter of Yarnbury argued:

“[The creative industries] are bigger than the financial services sector and provide jobs for around 2 million people. Recent technological advances—the internet, digitalisation and so on—are only increasing their potential. ... In an era which has seen manufacturing jobs halved since 1997, the creative sector is the new economy. Real value nowadays lies in design, not manufacture.”⁴⁶

The Work Foundation suggests that UK economic growth is likely to come from the ‘knowledge economy’, and as Vince Cable and George Osborne argue in the Government’s March 2011 publication *The Plan for Growth*:

“We must build a new model of economic growth – where instead of borrowing from the rest of the world, we invest and we save and we export”⁴⁷

Animation has significant export potential. The UK is already a world leader in the export of TV programmes, with international sales of over £1.3bn in 2009 – a 127% increase on 2006⁴⁸. And animation lends itself heavily to international exploitation.

In *The Plan for Growth*, the government explicitly recognise the importance of creating and holding onto intellectual property (IP), and aim to:

“significantly increase the level of support to IP-intensive businesses to ensure they can exploit their IP domestically and overseas”⁴⁹

Animation is therefore a perfect fit for the UK’s growth ambitions:

- It is knowledge intense
- It is IP generating
- It builds on material existing competitive strengths
- It has significant export potential

⁴⁴ http://www.culture.gov.uk/news/news_stories/8294.aspx

⁴⁵ <http://www.guardian.co.uk/commentisfree/2006/oct/27/comment.media>

⁴⁶ <http://www.theyworkforyou.com/lords/?id=2007-06-06b.1121.163>

⁴⁷ The Plan for Growth, HM Treasury / Department for Business Innovation and Skills

⁴⁸ UK Television Exports, UK Trade & Investment, PACT, 2009

⁴⁹ The Plan for Growth, HM Treasury / Department for Business Innovation and Skills

6. The challenges ahead

Key points

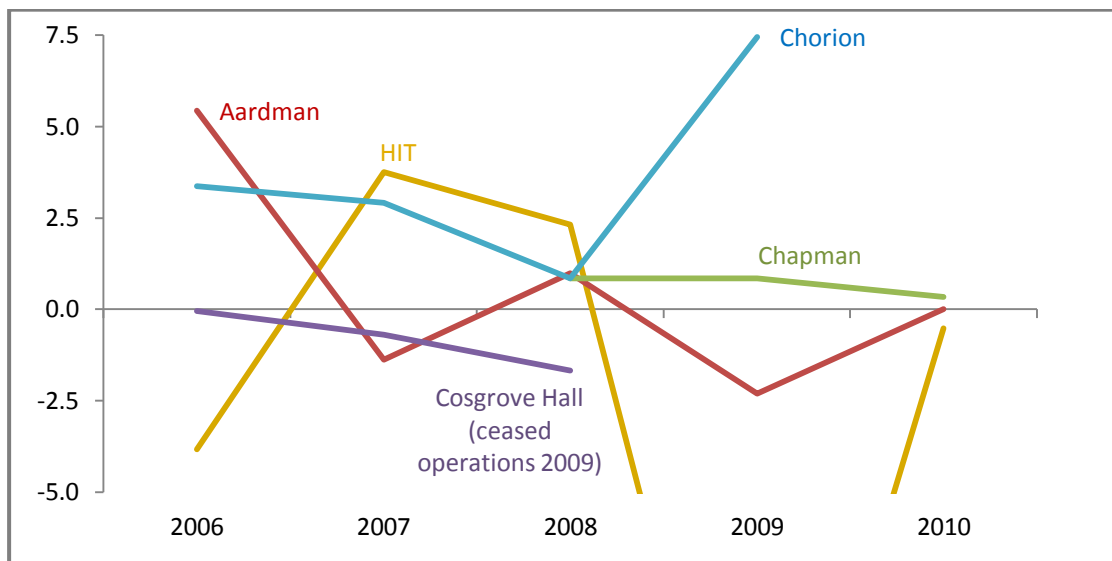
- UK animation companies have had moderate and volatile profitability
- Spend on animation by UK broadcasters has been falling, and DVD sales have been under pressure
- For certain types of work, low cost producers in developing markets are a competitive threat
- Most importantly, animators in the UK's direct competitors enjoy substantial government support

As we have seen, there is potential for real growth from UK animation. However, to capitalise on this the industry will have to overcome several challenges. We set these out in this section, but the industry believes it can itself tackle all but one – namely, the significant state support available to animators elsewhere but not in the UK.

Industry profitability

The last five years have been turbulent ones for UK animation:

Figure 9 Operating profit of leading UK animation companies (£m)



Notes:

1. Sourced from company accounts. Figures are for financial year with the largest overlap with the relevant calendar year. Figures adjusted for non-12-month financial years
2. Chapman had revenues less than £5.6m prior to FY2008, and was therefore not required to file accounts
3. Aardman received a £2.9m Film Tax Credit in 2009 (not included in the above)
4. Hit had an operating loss of £17m in 2009, increasing to £333m after a charge for impairment of goodwill
5. In some cases figures are for the relevant company's holding co – for instance, Chorion figures are those for Planet Acquisition Holdings

Profitability has been volatile. For leading players, return on sales has rarely been in double digits, and losses have been common. Overall, the trend has been downwards.

Note that the above includes both companies that are themselves animators (Aardman, Cosgrove Hall, Chapman) and companies that own animated brands but do not themselves necessarily produce animation (HIT, Chorion – shown with dotted lines). HIT previously did stop-frame work in the UK, but moved animation off-shore, given incentives available elsewhere.

The demise of Cosgrove Hall

Cosgrove Hall Films was an animation studio founded in 1976. It made a number of iconic animated series, including *Danger Mouse*, *Count Duckula*, *Postman Pat* and *Noddy*. However, after a number of years of financial troubles, it was ultimately shut down by owners ITV in 2009. Dwindling UK budgets for animation and increasing imports from overseas were cited as the cause.

These companies are certainly not the entire industry. However, they do represent a significant percentage of it, given that other notable players such as Blue-Zoo and Astley Baker Davies have revenues of less than £5.6m (and therefore are not required to file full accounts with Companies House).

Of the animators shown above, Chapman Entertainment is the only one that has made an aggregate profit over the four years 2007-2010. However, even Chapman recently announced they would be making “a significant number of redundancies”⁵⁰.

More generally, of the UK animation companies surveyed for this report, 40% said they were only breaking even or were loss-making. Clearly this is not the pattern of an industry that is (without change) likely to be attractive to investors.

We note from our own sample analysis of Skillset’s 2008 list of 624 UK animation companies that as many as 28% are no longer in business or have exited animation⁵¹.

Declining spend by UK broadcasters

In part these declines are due to a diminishing domestic market for UK animation.

Total hours of new UK Children’s Programmes broadcast on commercial PSB Channels have already fallen every year since 1999 with the aggregate reduction being over 25%.

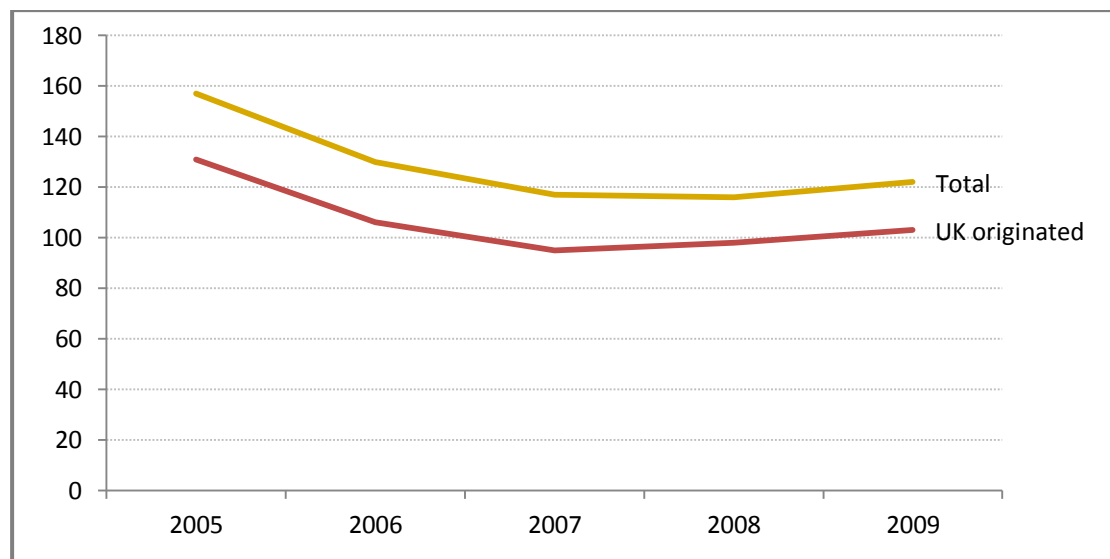
⁵⁰ See <http://www.broadcastnow.co.uk/news/people/chapman-co-founder-to-leave-ahead-of-redundancies/5030219.article>

⁵¹ Based on a sample of 269 animation companies, we found that only 194 now offered animation services. Of course, we recognise that new UK animation companies may have emerged in this period which would not be captured by Skillset’s 2008 census, although cursory analysis and anecdotal evidence suggest this is likely to be small in comparison to the number of closures

ITV1's output fell from approx. 450 to 375 and Channel 5's fell from over 250 to less than 175. In part this was driven by The Broadcasting Act of 2003, which removed the obligation on ITV and Channel 5 to carry children's television. However, Channel 4's output also fell from over 50 hours p.a. to virtually none.

The decline was compounded by Ofcom's decision in 2006 to ban junk food advertising around children's programmes. With lower commercial incentives to broadcast children's programmes, ITV1 moved them to the digital channel CITV, replacing them with higher-rating repeats of dramas such as Midsomer Murders.

Figure 10 PSB spend on children's programming (2009 £m)⁵²



There has been a slight recovery in the last two years, but this has been almost entirely driven by the BBC. CBeebies funding is up from £18m to £29m, 2006 to 2010. However, looking forward the BBC faces significant budget pressures, given its new spending obligations and the real terms reductions to the licence fee.

Spend by the commercial PSBs fell 27% from 2008 to 2009.⁵³ In terms of volume, hours of first run UK-originated PSB children's content fell from 1,745 in 2005 to 1,502 in 2009⁵⁴.

Furthermore, independent production has been hit disproportionately hard. While the total spend on in-house children's content fell by 23% from 1999 to 2009, spend

⁵² Ofcom, PSB Report 2010 – Information pack, 14 July 2010 http://stakeholders.ofcom.org.uk/binaries/broadcast/reviews-investigations/psb-review/psb2010/psb_output.pdf. PSBs covered are BBC One, BBC Two, ITV1, Channel 4, Channel Five, CBBC, CBeebies, S4C Digidol

⁵³ Ofcom, *Public Service Broadcasting Annual Report 2010*, 14 July 2010 <http://stakeholders.ofcom.org.uk/binaries/broadcast/reviews-investigations/psb-review/psb2010/psbreport.pdf>

⁵⁴ Ofcom, *PSB Report 2010 – Information pack*, 14 July 2010

on independently produced content fell by 34% (contrasted against a 17% rise total independent production spend over the same period)⁵⁵.

The PSBs are of course not the only broadcasters of children's TV in the UK. Disney, Viacom and Turner all have children's channels available. However all three of these broadcasters have their own US animation studios, on which they rely for much of their content. Consequently only Viacom (via Nickelodeon) currently invests meaningfully in UK originated content, commissioning shows such as *Grizzly Tales for Gruesome Kids* and *Humf* – however, this may not continue much longer. Disney is committed to producing six series per year in Europe, but financial incentives available on the Continent make it relatively unattractive to commission these in the UK.

Furthermore, global players such as these typically retain all the rights to the content they broadcast on their channels. They then have the scale, market power and distribution networks to fully exploit this. Nickelodeon, for example, has been able to keep *Dora the Explorer* on air on all their channels globally for over ten years.

Thus the contraction in broadcaster spend represents a challenge to UK animators, particularly in combination with international competition (discussed below).

According to Skillset:

*“the decline in commissions from commercial broadcasters and their advertisers presents a major threat to traditional 2D animators who are already affected by the growth of off-shoring to low cost centres of production.”*⁵⁶

These challenges are being felt by animation production companies and independents animators alike. Our survey of freelance animators found that 84% of respondents believed it had become harder to win TV animation production work compared to 3 years ago.

Declining market for home entertainment

An additional key source of revenue for animators, in addition to broadcaster sales, is home entertainment – retail sales of shows on DVD, Blu-ray or VHS, or via digital distribution. However, the home entertainment market in general is in decline. In both the US⁵⁷ and the UK⁵⁸, sales have been on a downward trend for several years, and are now below 2003 levels.

⁵⁵ Ofcom *Communication Market 2010*, Perspective Associates analysis

⁵⁶ Skillset, *The Animation Sector Profile*, 2008

http://publications.Skillset.org/admin/data/animatio%20sector%20profile/animation_sector_profile_-_full_length.pdf

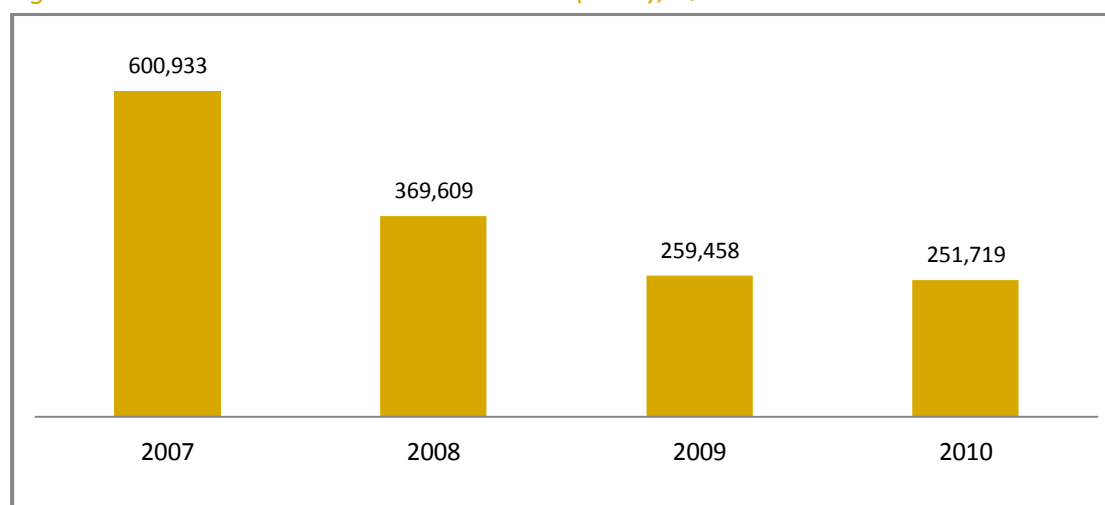
⁵⁷ DEG, *DEG Year-end 2010 Home Entertainment Report*, 6 January 2011, http://www.degonline.org/pressreleases/2011/f_Q410.pdf

“The availability of around-the-clock digital channels also has impacts on the DVD market and on pre-school children. Shows are available at any time and parents do not feel the need to buy DVDs for their kids.

Tim Wescott, Screen Digest ⁵⁹

There are reasons to believe that children’s home entertainment sales have been under particular pressure, due to the rise of children’s specialist channels and digital video recorders, both of which make available TV for pre-schoolers at times when there was previously nothing for them on. Certainly pre-school DVD sales have seen a steep decline in recent years:

Figure 11 Pre-school new release DVD sales (units), Q4⁶⁰



A highly international market

For the reasons above, UK broadcasters are growing less important as a source of funding for animated programming. A UK broadcaster might now represent 10-15% of the cost of producing a programme. Animation is an extreme case of a widespread trend in programming, whereby production companies have to tap multiple funding sources to cover the production budget – the days when a single broadcaster would underwrite the cost of a programme are long gone, and will not return.

Three funding sources (beyond a commissioning broadcaster) are particularly relevant for animation – sales to overseas broadcasters, DVD sales, and (for more successful shows) merchandising. In each case, the relevant market is an international one, not merely the country of origin. Animation works well across

⁵⁸ ERA, *Yearbook 2010* <http://www.eraltd.org/downloads/stats/VideoMarket.pdf> UK Film Council, *09 Statistical Yearbook*, 2009 <http://www.ukfilmcouncil.org.uk/media/pdf/2/p/2009.pdf>

⁵⁹ CARTOON, *Cartoon Masters 2010*, December 2010 <http://www.cartoon-media.eu/MASTERS/pdf/MAS-10-dissemination.pdf>

⁶⁰ Source: OCC (total sales of the top 10 pre-school new releases in each Q4)

borders – it is much easier to dub and it can be less culturally specific than live action. As a consequence, animation is a highly international market:

*Figure 12 International sales of animation (sample programmes and countries)*⁶¹

	64 Zoo Lane	Dora the Explorer	Mr Men	Peppa Pig	Shaun the Sheep
UK					
France					
Germany					
Spain					
Ireland					
Australia					
US					
China					

Thus UK animators need to win overseas business to cover their costs of development, and face international competition in their domestic market.

This international competition is likely to intensify as countries around the world recognise the opportunity to build successful animation industries of their own.

For example, statistics from the China Animation Association showed that in 2004, the production capacity of the country's entire animation industry was only 12,000 minutes. But it is estimated that more than 200,000 minutes of production will be created this year, and there are now nearly 7,000 registered animation companies around the country. The animated film *Legend of a Rabbit* will shortly be released in China, the first feature length production from a 4.5bn yuan (£420m) animation facility developed by the Chinese state. And even the film produced to showcase one-eyed monsters *Wenlock and Mandeville*, the mascots for the London 2012 Olympics, was produced in China⁶².

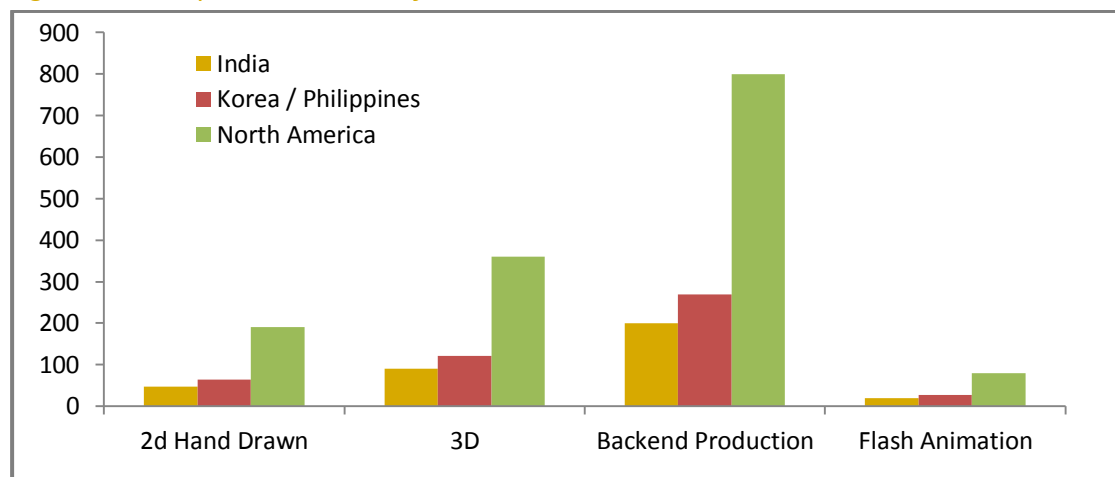
A market with low cost international rivals

While creative content development for animation today still is primarily done in Europe, North America and Japan, the actual production is increasingly outsourced to markets where labour is cheaper. The outsourcing of animation of *The Simpsons* to Korean studios such as AKOM and Anivision is well known. India is also a player of growing importance, albeit from a small base. The cost differential versus Western production costs can be material:

⁶¹ Perspective research

⁶² <http://www.ft.com/cms/s/0/567b7a04-9dbd-11df-a37c-00144feab49a.html#axzz1RPH5ZUaO>

Figure 13 Cost per 30 minutes of animation, US\$'000⁶³



It is partially for this reason that one industry expert recently commented “work for hire animation in the UK is a mug’s game”.

The impact of the UK’s Film Tax Credit

For films produced in the UK, production companies can claim a payable cash rebate that is worth up to 20% of UK expenditure (16% for films with total spend of over £20m).⁶⁴ To qualify, films must pass a ‘Cultural Test’ or be an official co-production, a process administered by the British Film Institute (BFI).

As we discuss later in this report, the Film Tax Credit is widely accepted to have had a positive impact on the UK film industry. Indeed, animated films have previously benefited from the scheme. However, the availability of such a scheme for film, but not for other forms of audiovisual content, has had the indirect impact of distorting the market for talent.

As we have discussed, there is significant (and growing) overlap between animation and film. For example, the UK animation industry works directly on animated features, and provides visual effects and post-production for Hollywood titles such as the hugely successful *Harry Potter* series.

The existence of the tax credit in film therefore increases market salaries for animators, putting further pressure on the budgets for TV animation.

Heavy government support in other countries

Heavy government support for animation in other countries is the greatest threat faced by UK animators. While they recognise the challenges presented by declining spend by domestic broadcasters and low cost overseas rivals, they do not believe

⁶³ Deloitte, *Animation. Broadcasting. Gaming. - On the Cusp of Growth*, 2010 http://www.deloitte.com/assets/Dcom-India/Local%20Assets/Documents/Animation_and_Gaming.pdf

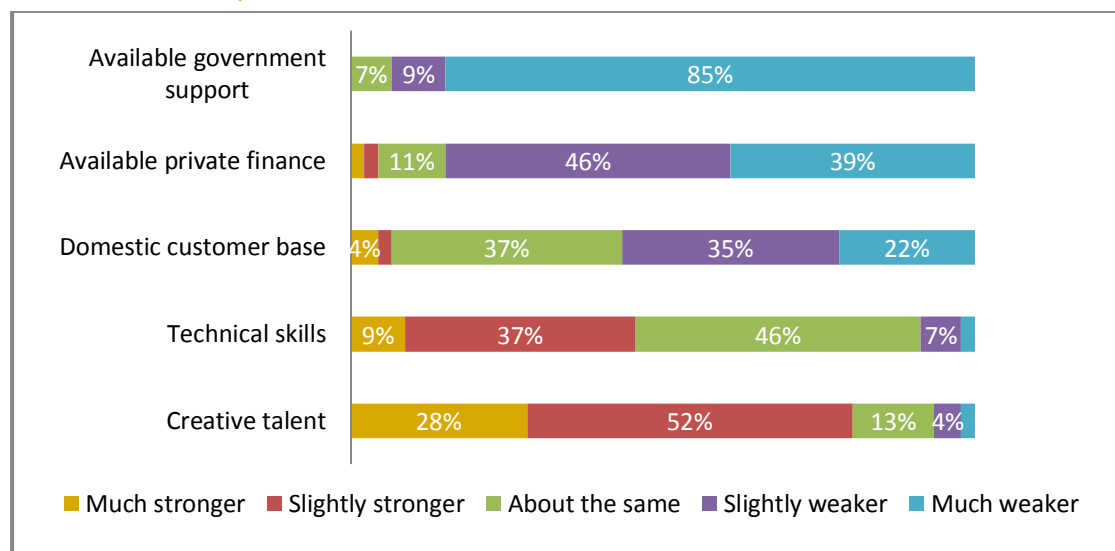
⁶⁴ UK Film Council <http://www.ukfilmcouncil.org.uk/taxrelief>

these issues are (by themselves) insurmountable. Generally, they feel that the UK's business skills, storytelling expertise and creativity are more than sufficient to offset them. According to Miles Bullough, Head of Broadcast & Executive Producer at Aardman Animations:

"If we can compete on a level playing field, we will win hands down".

However, the playing field is not level. Numerous governments around the world - unlike the UK - now provide substantial financial support for their animation industries (which we discuss in detail in the next section). UK animators report this as the country's most serious competitive disadvantage by some margin:

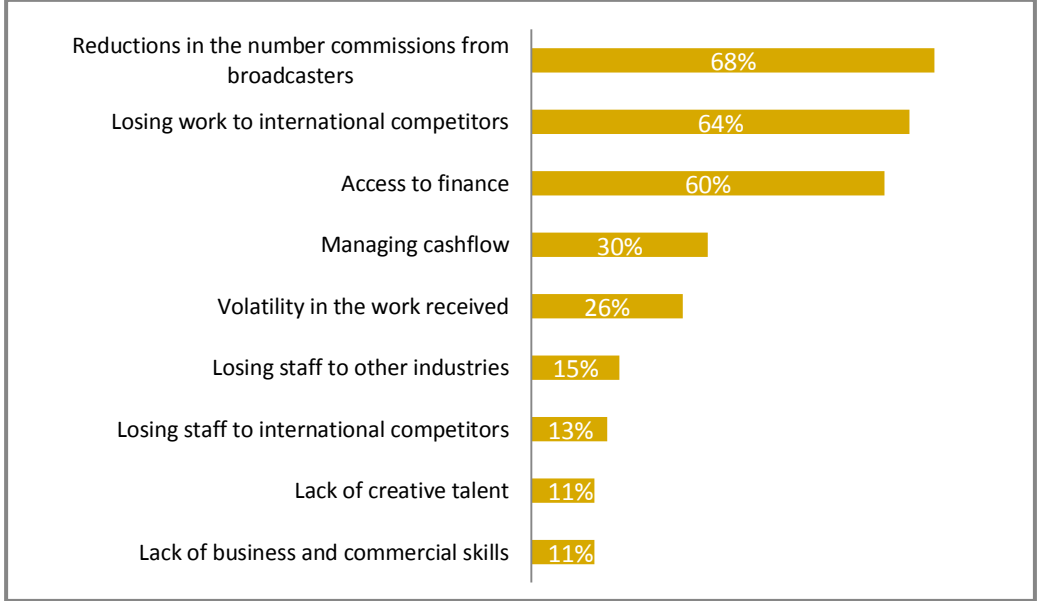
Figure 14: "How do you think the UK animation industry compares its main international competitors?"⁶⁵



Asked what they saw as the main threat to UK animation production, 64% of respondents cited 'losing work to international competitors', second only to 'reduction in broadcaster commissions' (68%).

⁶⁵ Perspective online survey of UK animation companies

Figure 15: What do you see as the main threats to animation production in the UK in the coming years?⁶⁶



In the next section we turn to the details of the government support available elsewhere.

⁶⁶ Perspective online survey of UK animation companies

7. Overseas support for animation

Key points

- Numerous countries provide substantial government support for their animators
- This typically takes the form of tax credits, investment funds or quotas
- This can often provide 20% or more of the production budget
- Such funds have been successful in growing the animation sectors of the countries concerned
- With some very minor exceptions, the UK has nothing to match such support

Government support, both national and regional, is available in many countries around the world. Many governments believe that support for domestic animation carries both economic and cultural benefits. France, Ireland and Canada have been particularly supportive. We discuss them first, before taking a global perspective.

Support available in France

France operates a range of national and regional mechanism to support domestic production of animation. Most important of these is the CNC (Centre National de la Cinematographie), which has substantial funds available to support both film and television production. These are distributed through a wide variety of programmes, which (in 2010) provided €29.5m for French animation projects.

Figure 16 Key CNC funds available to French TV, including animation (2009)⁶⁷

Name In English	Support	Awards (€m)
COSIP: Automatic Support for Production	Production	140.1
COSIP: Advance on Rights to Automatic Production Support	Production	30.9
COSIP: Selective Support for the Production of Television Programmes	Production	27.3
Support for Project Development for Television Works	Project Development / Pre-production	7.6
Picturing Diversity	Distribution / Production / Project Development / Pre-production Screenwriting & Script Development	3.6
Support for Promotion and International Sales of Television Works	Promotion (Markets, Festivals & Sales)	1.2
Selective Support for Video on Demand	Video on Demand	1.1

In addition to CNC there is also a tax break for investors, known as SOFICA, for those funding film or animation via specified vehicles, enabling individuals to reduce their

⁶⁷ European Audiovisual Observatory, *KORDA*, retrieved 1 July 2011 <http://korda.obs.coe.int/korda.php/organisation/indexType1/id/38>

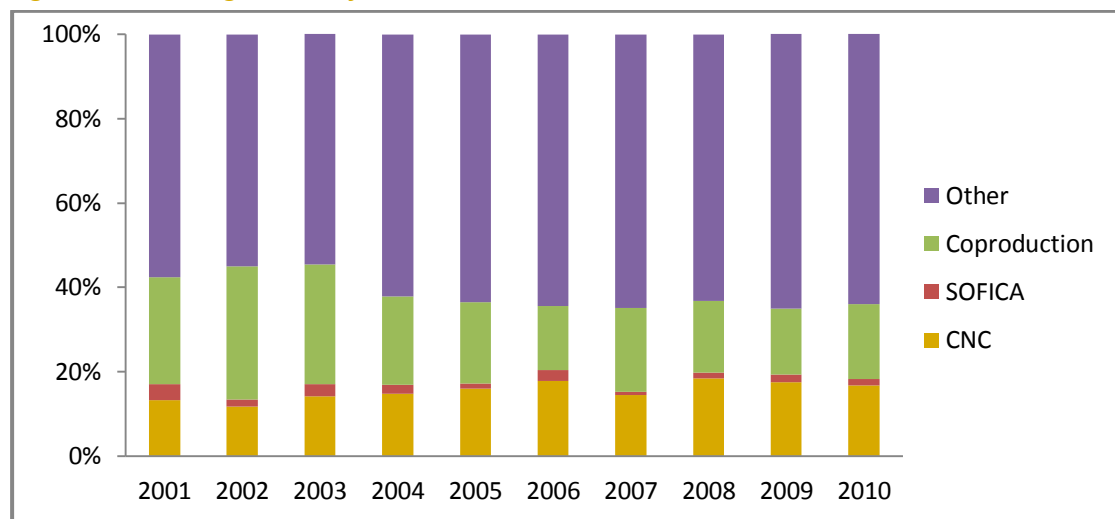
income tax by up to 48% of the amount invested. In 2010 SOFICA vehicles invested €2.9m in French animation⁶⁸

There is also a tax break for production companies, the ‘Credit d’impot’. Subject to a cultural test, this can fund (either as a tax offset or grant) 16% of the cost of an animated programme or film.

Finally, there are numerous regional funds supporting AV production. The largest of these, Fonds de soutien de la Région Île-de-France, has a budget of €16m, and (for example) provided €350,000 for the latest series of *Garfield*.⁶⁹

In combination, these sources have made a substantial contribution to the production budgets of French animation. CNC and SOFICA funds typically represent just under 20% of funding:

Figure 17 Funding sources for French animation⁷⁰



As a result of the support offered, the volume of animated content produced in France has increased considerably over the last 20 years.

⁶⁸ CNC, *Le marché de l'animation en 2010*, June 2011

http://www.cnc.fr/web/fr/publications?p_auth=d8sp0Fjd&p_id=20&p_p_lifecycle=1&p_p_state=exclusive&p_p_mode=view&p_p_col_id=column-1&p_p_col_count=1&_20_struts_action=%2Fdocument_library%2Fget_file&_20_folderId=54953&_20_name=DLFE-3405.pdf

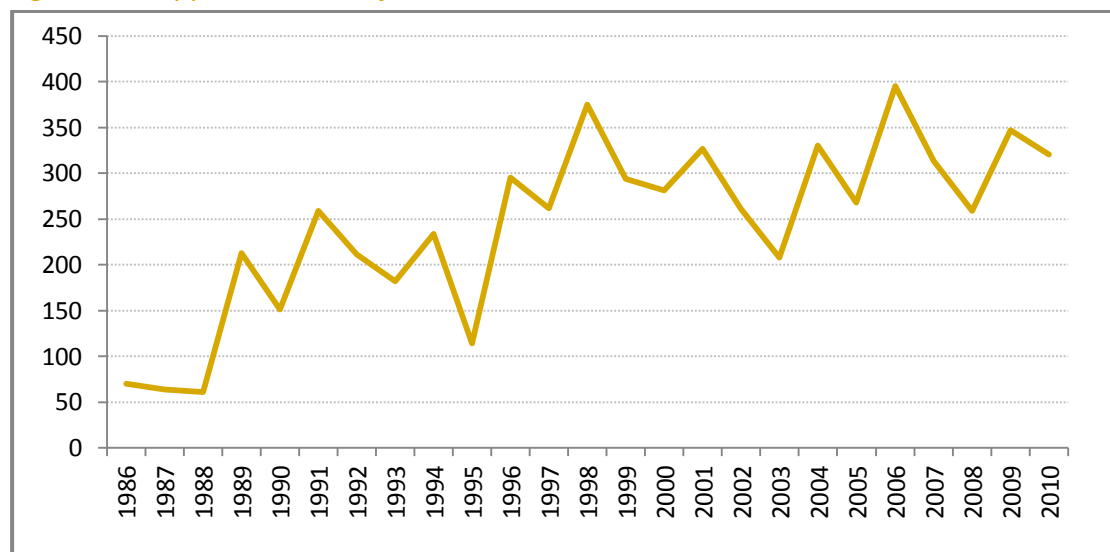
⁶⁹ European Audiovisual Observatory, *KORDA*, retrieved 1 July 2011

<http://korda.obs.coe.int/korda.php/organisation/indexType1/id/46/tab/4>

⁷⁰ CNC, *Le marché de l'animation en 2010*, June 2011

http://www.cnc.fr/web/fr/publications?p_auth=d8sp0Fjd&p_id=20&p_p_lifecycle=1&p_p_state=exclusive&p_p_mode=view&p_p_col_id=column-1&p_p_col_count=1&_20_struts_action=%2Fdocument_library%2Fget_file&_20_folderId=54953&_20_name=DLFE-3405.pdf

Figure 18: Supported hours of animated TV content in France⁷¹

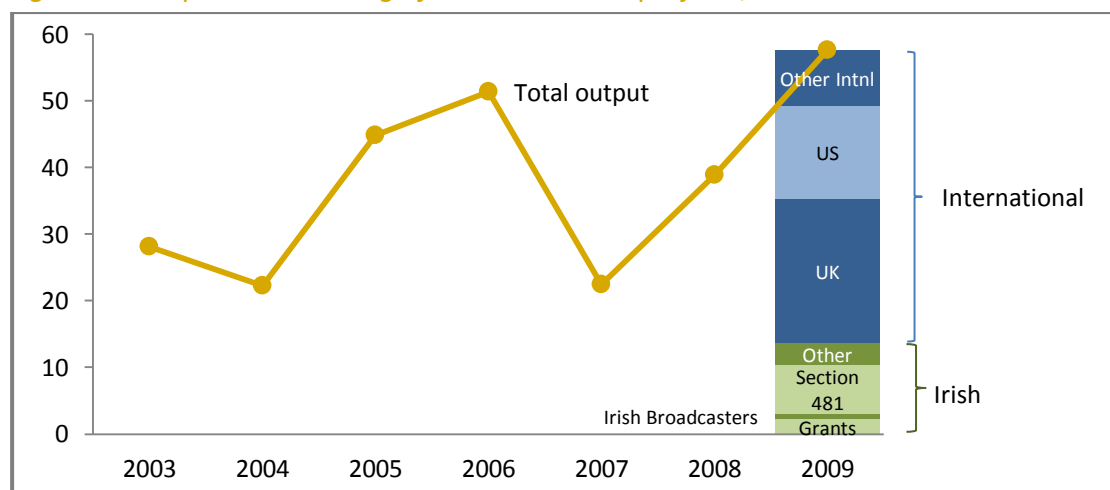


Support available in Ireland

The Irish Film board (IFB) provides grants and loans for local animation, which totalled €1.1m in 2009.⁷² There is also 'Section 481' tax relief available (not dissimilar to the SOFICA structure in France), which is worth up to 28% of the costs incurred in Ireland. It provided a benefit of €7.3m for animation in 2009.⁷³

Consequently Irish animation has enjoyed significant (albeit volatile) growth, in part by attracting substantial US and UK funds:

Figure 19 Output and Funding of Irish animation projects, €m⁷⁴



According to Emma Scott of the Irish Film Board:

⁷¹ CNC, Perspective Associates analysis

⁷² European Audiovisual Observatory, *KORDA*, retrieved 1 July 2011
<http://korda.obs.coe.int/korda.php/organisation/indexType1/id/143>

⁷³ IBEC, *Film & Television Production in Ireland, 2010* <http://www.irishfilmboard.ie/files/reports/AF%20Review%202010.pdf>

⁷⁴ IBEC, *Film & Television Production in Ireland, 2010* <http://www.irishfilmboard.ie/files/reports/AF%20Review%202010.pdf>

“IFB funding is vital for [Irish animators] to develop and subsequently exploit their own IP. Without content-ownership we would become merely a service industry, which while valuable in terms of gaining experience and paying overheads, leaves companies vulnerable to competition from low-cost labour economies, such as India.”⁷⁵

While the scale of the support is not as high in Ireland as it is in France, it carries a particular threat to the UK, since common language and humour plus proximity make it an attractive place for UK commissioners and producers to do business. CBeebies’ *The Octonauts* and Channel 5’s *Olivia* are both produced in Ireland (for Chorion), and 38% of funding for Irish projects came from the UK in 2009.

Support available in Canada

At a national level Canadian producers can apply for the CPTC (Canadian Film or

“The amount of government support for audiovisual works in Canada is quite staggering”

Neil Court, NED, DHX Media⁷⁶

Video Production Tax Credit). This credit is set at 25% of qualifying labour spend, which is capped at 60% of total production costs, so is worth up to 15% of the total cost.⁷⁷

The Canadian Film and TV Production Association has commented that this credit (and another similar one, the PSTC) “have been a critical component in the growth of the industry”.⁷⁸

In addition, Canadian provinces also provide substantial tax credits, in most cases actually greater than those provided by the federal government.

Further support at the national level is available from the Canadian Television Fund⁷⁹, a public/private initiative funded by the federal government and pay TV operators, which provided C\$21m for Canadian animation in 2009/10

In 2009/10, 29% of funding for Canadian children’s TV production (of which animation was just over half) came from federal and provincial tax credits, and a further 17% from the Canadian Television Fund. In aggregate, total public support provided 47% of budgets.⁸⁰

⁷⁵ IFTN, *Spotlight on Irish Animation: Interview with Irish Film Board Production Executive Emma Scott*, 16 June 2011 <http://www.iftn.ie/news/?act1=record&only=1&aid=73&rid=4283989&tpl=archnews&force=1>

⁷⁶ CARTOON, *Cartoon Masters 2010*, December 2010 <http://www.cartoon-media.eu/MASTERS/pdf/MAS-10-dissemination.pdf>

⁷⁷ Cassels Brock, *An Overview of Canadian Tax Credits For Non-Indigenous Film and Television Production*, March 2011, http://www.americanbar.org/content/dam/aba/migrated/2011_build/entertainment_sports/overview_canadian_tax_credits.authcheckdam.pdf

⁷⁸ CFTPA, *Submission to the House of Commons Standing Committee on Finance with respect to the 2010 Pre-Budget Consultations*, 13 August 2010 http://www.cftpa.ca/government_relations/pdfs/2010%20Pre-budget%20Consultations%20-%202010%20August%2013%20-%20FINAL.PDF

⁷⁹ The CTF was merged into a new entity, the Canadian Media Fund, on 1 April 2010

⁸⁰ CMPA/APFTQ, *An Economic Report on the screen - based production industry in Canada*, 2010 <http://www.cftpa.ca/newsroom/pdf/profile/Profile2010Eng.pdf>

Support available in other countries and co-production treaties

While we have discussed France, Ireland and Canada in relative detail, these are just leading examples of what is a widespread practice. Numerous other countries support their animation industries:

Figure 20 International support for TV animation (selected countries)⁸¹

	Australia	Belgium	Brazil	Bulgaria	Canada	France	Germany	Hungary	Ireland	Italy	Luxembourg	Malaysia	New Zealand	Romania	S Korea	Singapore	Slovak Republic	Spain	Taiwan	USA
Tax credits																				
Funds																				
Quotas																				

While the support available from individual countries is substantial, it is often possible for a single production to benefit from support from two different countries. Numerous bilateral treaties exist that allow work done in one country to qualify as work done in the other, for the purpose of qualifying for government support. Canada, for instance, has more than 20 such treaties.⁸² By combining support from two different countries, projects can acquire over 50% of their funding from government programmes.

Quotas

In addition to funding support, many countries impose quotas on broadcasters for minimum amounts of children's programming, or in some cases specifically for animation. For instance, Korea requires that 45% of broadcast animation on terrestrial TV must be domestically produced, and animation must be at least 1% of total broadcast hours.⁸³ In France, the second largest commercial channel (M6) must invest 1% of its turnover in animation. TF1 must invest 0.6%. Children's specialist channels must invest much higher percentages in French animation – 10% for Disney for example.⁸⁴

Infrastructure

In other countries, support is provided in the form of infrastructure and technology. For example, in China the National Animation Industry Park opened in May 2011,

⁸¹ Perspective research. Includes certain regional programmes. Some quotas are for children's TV generally

⁸² CARTOON, *Cartoon Masters 2010*, December 2010 <http://www.cartoon-media.eu/MASTERS/pdf/MAS-10-dissemination.pdf>

⁸³ Hyekyung Lee, *Government Support in Animation Industry for Its Growth*, 18 July 2008 http://www.accu.or.jp/cc/jp/animation/img/KoreaHL_no1.pdf

⁸⁴ Ofcom, *The international perspective*, 3 October 2007, <http://stakeholders.ofcom.org.uk/binaries/consultations/kidstv/annexes/international.pdf>

and is part of a \$695m government programme to stimulate the domestic animation industry. As part of this, animation producers can rent space and equipment at the government managed facility at subsidized rates.

Available support in the UK

By contrast to this extensive support elsewhere, there is very little available in the UK. The Wales Creative IP Fund, set up in 2005, had a budget of £7m for a variety of media, and did invest in several animation projects (though film was its main focus). However, in 2010 the Hargreaves Review⁸⁵ recommended it be replaced by a new creative industries fund. This was due to be in place by April of this year⁸⁶, but does not appear to have been launched.

The agency Creative Scotland has an annual budget of £3m for investment across all of film and TV, but animation's share of this seems to have been minimal.

Calon TV received £1m from the Welsh IP Fund to support two series of *Hana's Helpline* and one of *Igam Ogam*. Production of these shows employed 40 highly skilled animators over a four year period, and generated around £6.5m in production turnover. However, without IP Fund support, the next series of *Igam Ogam* will now be co-produced in Ireland. £1.5m of production work will move there and ownership of IP in Wales has been diluted by around 30% as a result

UK producers can access EU funds. The 'Media' programme provides grants for European TV productions. However, it is relatively modest in size given its scope – annual grants are typically around €10m, and this covers a range of genres (not just animation) and the entirety of the EU. UK animators have been relatively successful in their applications, but grants received in 2010 were €984,000 in 2010, across four productions.⁸⁷ Of course grants from the Media programme are also available to EU competitors such as France and Ireland (in addition to the national support available there), and so it does not offset the competitive advantage stemming from that national support.

There is substantial support for film available in the UK, including both tax credits and £27m of lottery funding,⁸⁸ However, animated films are rare. Of the leading UK animators, only Aardman regularly makes feature films, and its last release was *Flushed Away* in 2006 (though it currently has two films in production⁸⁹). The

⁸⁵ Ian Hargreaves, *The Heart of Digital Wales: a review of creative industries for the Welsh Assembly Government*. 19 July 2010 http://culture.research.glam.ac.uk/media/files/documents/2010-07-19/Hargreaves_Review.pdf

⁸⁶ Ieuan Wyn Jones, *Written statement – Hargreaves Review*, 25 March 2010 <http://wales.gov.uk/about/cabinet/cabinetstatements/2010/100325har/?lang=en>

⁸⁷ See lists of grants at http://ec.europa.eu/culture/media/programme/producer/tv/results/index_en.htm

⁸⁸ Guardian, *British Film Institute to oversee 60% rise in movie industry lottery funding*, 29 November 2010 <http://www.guardian.co.uk/film/2010/nov/29/british-film-institute-ed-vaizey>

⁸⁹ Due for release in November 2011 and March 2012

support for film does assist some individuals working in animation, since their CGI skills can be applied more generally on feature films. However, this does have the unfortunate side-effect of increasing their cost (since pay is generally better on films), to the detriment of animation companies.

8. Impact of international support on UK animators

Key points

- International support for animation enables broadcasters to pay less, to the detriment of those producers without such support
- Securing project funding thus takes longer for UK producers, and this reduces their scale and increases their risk
- UK animators have turned to co-production with overseas partners in response
- However, this transfers expertise overseas and contributes to an erosion of the UK's competitive advantage

The increasing availability and scale of government support for animation around the world (and the absence of it in the UK) has had a range of serious negative impacts. This has started a 'hollowing out' of UK TV animation, and in time could lead to the sector's demise.

Reduced revenues from domestic broadcasters

Broadcasters are aware that that government support is available to animators, and as a result are willing to contribute less to production budgets (since they know programmes will be made even with lesser investment from them). While domestic broadcasters might once have funded 25% or more of a project, 10-15% is now a more typical figure (though the BBC does sometimes go higher). In some instances broadcasters are requesting to receive shows for free.

Longer project lead time

This (combined with other market trends, such as declining DVD sales) are making it much harder for UK animators to secure 100% of the funding they need for projects. Whereas a French producer might typically secure 55-60% of their funding from domestic broadcasters and government support, leaving only 40-45% to find, a UK producer might have 20% from a domestic broadcaster, leaving 80% to find.⁹⁰

In many instances, this simply means that shows are not made, but even those that do get made are taking much longer to finance. Industry executives report that while financing used to take 6-12 months, 18-24m is now more typical. In some cases, financing can take up for four years.

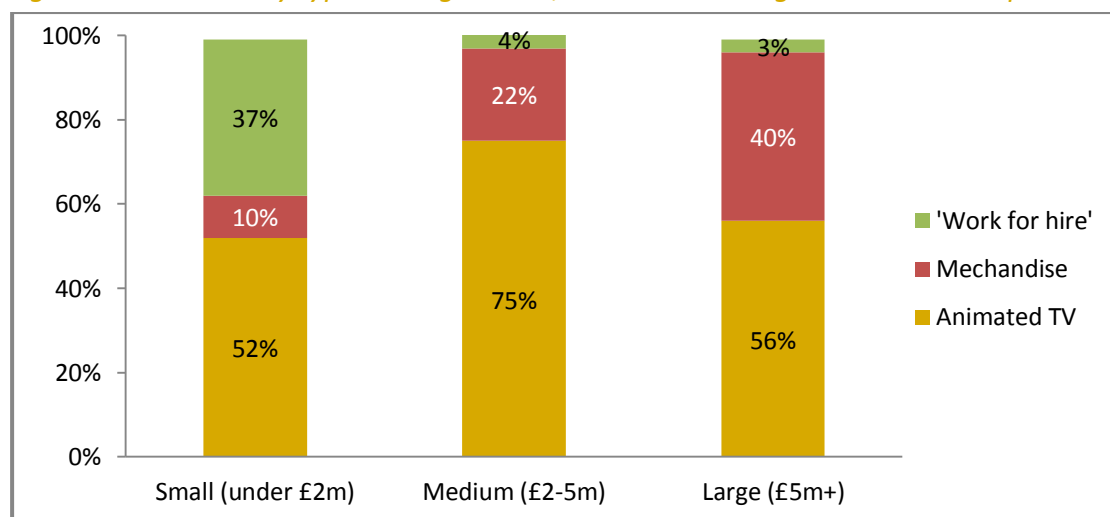
⁹⁰ Cartoon Masters 2010, industry interviews, Perspective Associates analysis

Reduced scale and increased risk

This has a double effect – obviously if it is more difficult and more time consuming to fund projects, then fewer will be completed, with a direct impact on the scale of the UK industry. However, this has a secondary impact. Animation production is a portfolio business. The successful shows, with multiple series and substantial merchandising, represent a high percentage of industry profits. However, as with any such industry, it is therefore important to have a healthy portfolio – with only a small number of shows, there is no guarantee that any of them will be hits, which can have severe consequences. A reduced number of projects affects both the scale and the stability of the industry.

Scale is also important because it is highly interlinked with ability to exploit IP rights. According to our survey of UK animation companies, the largest companies (with turnover of £5m and over) received 40% of their revenue from merchandise and ancillary revenue. For smaller animation companies, a lack of access to finance and pressure to chase lower value ‘work for hire’ projects (such as corporate videos, stings, titles and website) mean that rights are infrequently held. Of animation companies with turnover of less than £2m, 37% of revenue came from ‘work for hire’ projects, and just 10% from ancillary sources.

Figure 21: Revenue by type amongst small, medium and large animation companies⁹¹



Fewer commissions from non-UK broadcasters

We were told that it is now very rare for international or non-UK broadcasters to undertake commissions in the UK, save a small number of co-productions. The incentives elsewhere mean that, despite the UK's perceived strength in certain








⁹¹ Perspective Associates survey of animation companies (unweighted)

areas, the work flows to countries such as France, Canada or Ireland. Of respondents to the Perspective survey of animation companies, only 23% had worked on any project (TV or otherwise) that had originated overseas, despite the international nature of the industry.

Co-production as a response

UK animators have reacted to these challenges by co-producing numerous projects overseas. By working with another company based in a country providing support for animation, the UK company can benefit from that support. Typically, character development and scriptwriting might take place in the UK, but the animation is done elsewhere. A selection of UK animators and the location of animation for their key properties shows how common a practice this has become:

Figure 22 Country of production for selected UK animated properties

HIT	Chorion	Entertainment One	Aardman
Thomas & Friends  	Noddy  	Peppa Pig  	Wallace & Gromit  
Bob the Builder  	Mr Men  	Humf  	Shaun the Sheep  
Angelina Ballerina  	Octonauts  		Chop Socky Chooks  
Mike the Knight  	Olivia  		
Rainbow Magic  			
	Rastamouse Co Rastamouse  	Blue Zoo Kerwhizz Kids  	
		Get Squiggling  	
		Alphablocks  	
			Chapman Fifi  
			Roary  

While it has been a necessary step for many UK animators, co-production carries significant cost, both in the short and long term.

In the short term, a UK company will typically have to surrender substantial IP rights to the partner firm, giving up a share of future revenues from merchandise, DVD sales and so on. According to Karl Wooley, Managing Director of Impossible Kids, in a recent interview “You’re lucky if you manage to hang on to 25% of [the IP]”⁹³ Darrall Macqueen co-founder Billy Macqueen reports:

For the series *Chop Socky Chooks*, Aardman felt that government support was essential for the project to be commercially viable. It therefore partnered with a Canadian firm, DHX Media, which was able to access Canadian tax breaks. Consequently, of the 90 people working on the series, 70 were based in Canada⁹²

*“There’s no doubt that the business of animation production is getting tougher. We are still coming up with brilliant ideas but we are losing large chunks of the IP to external investors and people who can offer tax breaks”*⁹⁴

The practice of co-production also carries co-ordination costs, as two companies work jointly on a single project (these are often estimated at 10% of total costs). Creative decisions also become subject to compromise. This often reduces the ‘Britishness’ of the final product, and sometimes can lead to a flawed product.

Erosion of the UK skills base

In the longer term, a cost of co-production is that it leads to a leaching away of the UK firm’s expertise and knowledge. As one senior UK animation executive put it:

“When we do a co-production, our partner watches us like a hawk- how we edit the script, which writers we use, how we do character design, story boarding and so on.”

While the UK has a real competitive advantage from its distinct animation skills, this advantage is being diminished by the very practice of co-production which is currently essential for survival.

In addition to this skills transfer between companies, skills are also being lost via employee emigration. The animation workforce is a relatively young one – 47% of employees are under 35, compared to 36% for the wider economy⁹⁵. As a consequence, the workforce is mobile. As the opportunities for UK animators have

⁹² Telegraph, *Animation industry could be 'extinct' in five years*, 18 November 2009, <http://www.telegraph.co.uk/culture/culturenews/6598511/Animation-industry-could-be-extinct-in-five-years.html>

⁹³ Televisual, *The UK's toon time*, August 2011

⁹⁴ Televisual, *The UK's toon time*, August 2011

⁹⁵ Skillset, *Animation Sector – Labour Market Digest*, 2009 http://www.Skillset.org/uploads/pdf/asset_13238.pdf?3

contracted, and those available in international markets have grown, individuals are moving overseas in the search for work.

Amongst freelance animators recently surveyed by Perspective Associates, 36% said they were currently considering a move overseas for work, and a further 40% had considered it in the past⁹⁶. Many animators have already left. For example, almost one third of Aardman Animation's former employees now work abroad, with the US, France and Canada being the top destinations⁹⁷. This represents both a loss of skills for the UK, and a gain for its rivals.

The combination of sustained government support and skills transfers of these types mean that several other countries are now credible players in the international animation market, that simply would not have been considered previously.

A 'hollowing out'

Animation production in the UK has been contracting in the face of these challenges. However, character rights ownership and pre-production remains (comparatively) stronger, with companies such as HIT and Entertainment focused in this area.

Such a focus is entirely feasible for individual companies, but it is less clear that it is viable for the sector as a whole. The craft skills and feel for animated story telling that young animators learn working in production contribute to their later ability to create characters and scripts. For example, HIT Entertainment's latest character, 'Mike the Knight', was created by Alexander Bar, who began his animation career with Pepper's Ghost Productions.

Thus the contraction of production may later weaken the creativity of the UK sector's character development and pre-production.

⁹⁶ Sample of 27

⁹⁷ Perspective analysis of LinkedIn data

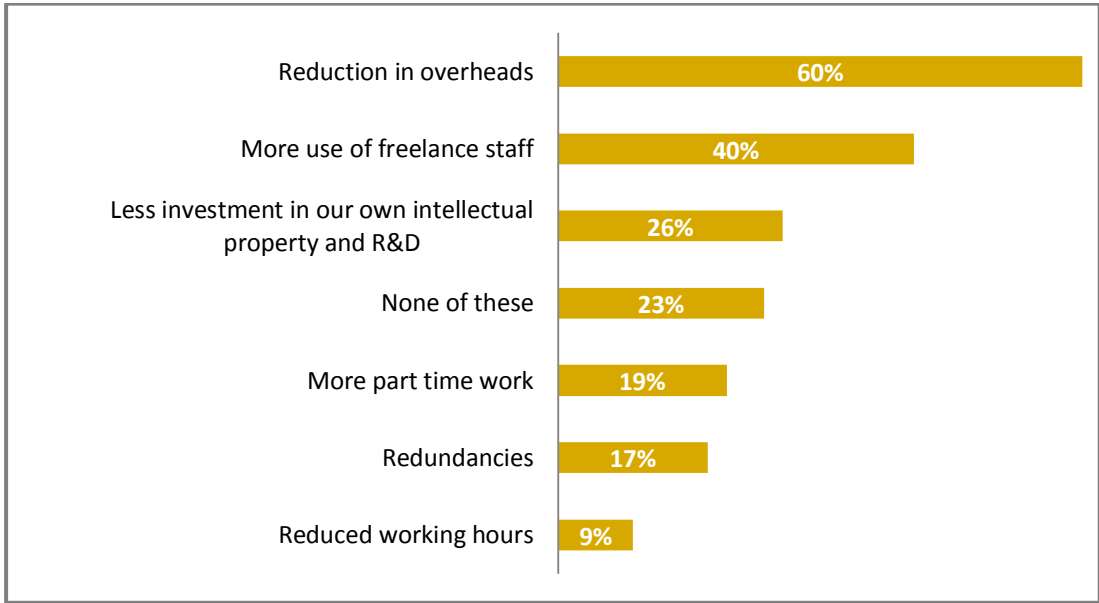
9. The future for UK animation, absent government action

Key points

- If there is no material change, the UK’s animation sector is likely to continue to contract – more players will exit the business, and the survivors will gradually do a diminishing number of projects
- Initially the impact will primarily be on production, but over time pre-production and IP ownership will also be badly affected

As we have seen, UK animation has a significant competitive disadvantage relative to its rivals as a result of the government support they receive. The vast majority of animation companies who responded to our survey had already undertaken some form of cost efficiency over the last year (77%). Of these, many had sought to reduce overheads or shift to greater use of freelance staff. Around a third of those implementing cost efficiencies had reduced investment in their own R&D.

Figure 23: Over the last financial year, has your company made use of any of the following cost efficiencies?⁹⁸



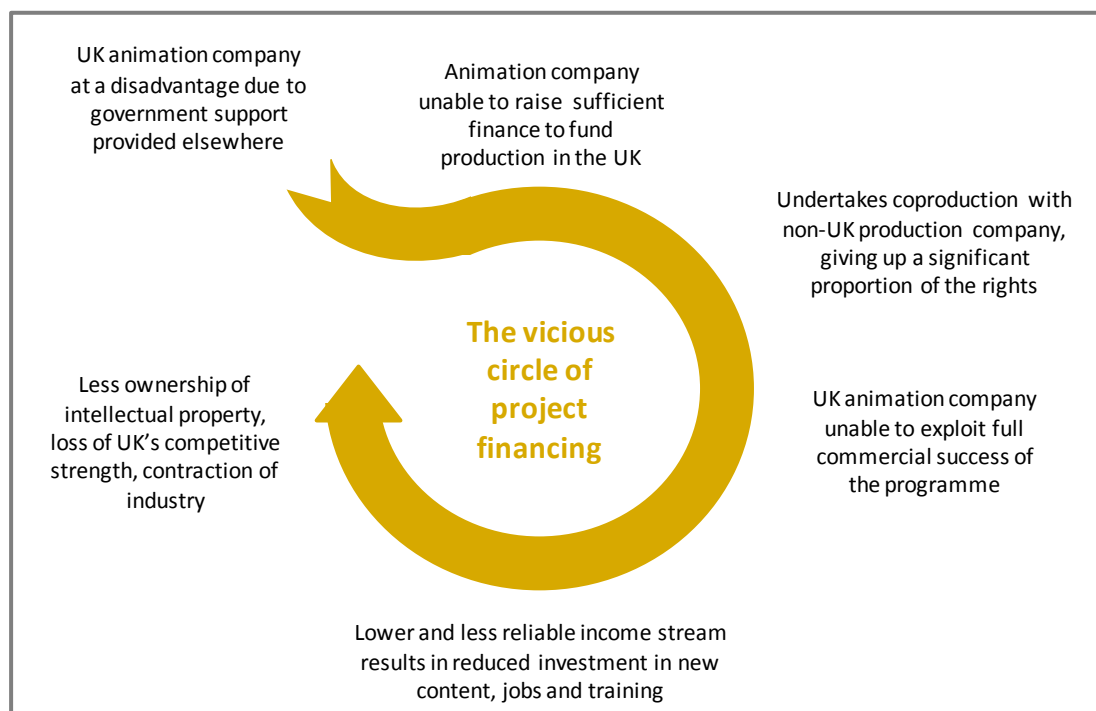
⁹⁸ Perspective online survey of UK animation companies

If this status quo continues, UK animation is likely to face some very serious consequences:

- *The scale of UK animation will be under pressure*, as long project lead times and financing challenges reduce the number of projects launched
- *Animation production is likely to continue to move overseas*, as co-production becomes increasingly important to funding
- *Over time, pre and post production will also contract*. Fewer projects today will mean smaller future revenue streams tomorrow to reinvest. Moreover, if the projects that *do* go ahead today are co-productions, then the UK entity will hold only a share of rights that bring future revenues
- *An increasing number of players are likely to withdraw from the market*. The industry is not particularly profitable today, and the above trends will both reduce overall profitability and increase risks, which will likely see ever more players wound up

This creates a ‘vicious circle’, where a lack of domestic government support makes financing projects more and more difficult. UK animators are increasingly unable to hold onto their intellectual property, the financial benefits of UK creativity are lost, the domestic animation sector contracts, and skills, jobs and talent leaves the market.

Figure 24: Illustration of the ‘vicious cycle’ of project financing



In short, absent government action, UK animation may simply cease to be viable, having a damaging effect on the UK's underlying skills bases, on related industries such as gaming and post-production, and on the production of UK-originated children's content.

10. Potential responses

Key points

- Potential government responses include the introduction of a tax credit to cover animation similar to the Film or R&D Tax Credits; an investment fund; or quotas
- We believe the introduction of a tax credit for animation modelled on the Film Tax Credit is the best option, though it could be adapted to limit its scope to those projects where material IP is to be held in the UK

There are a range of tools the government can use to ensure the health and growth of the animation sector. These include:

An animation tax credit similar to the Film Tax Credit

For films produced in the UK, production companies can claim a payable cash rebate that is worth up to 20% of UK expenditure (16% for films with total spend of over £20m).⁹⁹ To qualify, films must pass a 'Cultural Test' or be an official co-production, a process administered by the BFI.

This incentive is seen to have been highly effective, not least in attracting Hollywood investment to the UK, and "tax credits are now regarded as fundamental to the sustainability of the British film industry".¹⁰⁰ According to Oxford Economics (in a report for the Film Council):

*"without the UK Film Tax Relief in place, we estimate that its film production would be around 75% smaller, reducing UK GDP by around £1.4 billion a year and Exchequer revenues by about £400 million a year. Since the Film Tax Relief costs HM Treasury around £110 million a year, this means it generates about £13 in GDP for every £1 invested"*¹⁰¹

While it is well regarded, one concern sometimes raised regarding the Film Tax Credit is that it has supported a service industry undertaking work-for-hire for overseas owners of IP (primarily American), rather than an industry developing its own IP and exporting this to the world. This is an unlikely outcome for animation, since even in current circumstances the industry is already generating substantial IP.

In 2010 the House of Lords Communications Committee report on the British Film and Television Industries recommended introducing a similar tax credit for animation:

⁹⁹ UK Film Council <http://www.ukfilmcouncil.org.uk/taxrelief>

¹⁰⁰ Magor, M. and Schlesinger, P. 'For this relief much thanks.' *Taxation, film policy and the UK government*. Screen, 2009 <http://eprints.gla.ac.uk/39608/1/MagorSchlesingerScreen2009.pdf>

¹⁰¹ Oxford Economics, *The Economic Impact of the UK Film Industry*, June 2010, <http://www.oxfordeconomics.com/samples/oeffilmindustryjune10.pdf>

*“We believe there is a strong case for extending the tax credit help to UK content made for television... [A] number of programming genres are under particular pressure. Among these are children's programmes, including animation. The tax credit could enable support to be directed not only towards British production but also to particular kinds of production. It would then be possible to target help and to measure how effective that proved to be. We recommend the extension of the film tax credit, on a pilot basis, to children's programmes and animation productions made for television.”*¹⁰²

As a form of assistance to animation, the introduction of a tax credit modelled on the Film Tax Credit would be relatively straightforward given the existence of legislation and processes that are already successfully operating.

An animation tax credit similar to the R&D tax credit

The R&D tax credit provides tax relief on 200% of qualifying R&D expenditure for SMEs (increasing to 225% in 2012). Businesses not in profit can instead receive a cash payment of around 25p per pound of qualifying expenditure.¹⁰³ To qualify, expenditure must be for "work to resolve scientific or technological uncertainty aimed at achieving an advance in science or technology".¹⁰⁴ In 2008/09 the scheme provided relief worth £940m.¹⁰⁵

As with the film tax credit, the R&D tax credit is seen to be highly effective. According to a CBI survey, 37% of claimants had increased their R&D spending due to the credit, 50% said it had directly helped maintain their UK R&D spend, and 76% reported indirect benefits that again helped maintain spend.¹⁰⁶ In light of this, in the 2011 budget, the government announced an increase in the levels of credit, and widened the range of expenditure that could qualify.

The R&D credit is used within the creative industries – in particular, the gaming sector. One of the purposes of the R&D tax credit has been to support the development of UK-owned IP, and to that extent it is relevant to UK animation. However, in practice there is very limited spend within the animation sector that is to “resolve scientific or technological uncertainty”, and consequently the current R&D tax credit has had little or no benefit for the sector.

¹⁰² See <http://www.publications.parliament.uk/pa/ld200910/ldselect/ldcomuni/37/3708.htm>

¹⁰³ Business Link, *R&D Tax Credits* <http://www.businesslink.gov.uk/bdotg/action/detail?itemId=1086266055&type=RESOURCES>

¹⁰⁴ BIS, *About R&D Tax Credits*, <http://www.bis.gov.uk/policies/innovation/business-support/rd-tax-credits/about>

¹⁰⁵ HMRC, http://www.hmrc.gov.uk/stats/corporate_tax/rd-receiptsbasis.pdf

¹⁰⁶ CBI, *Impact of the R&D Tax Credit*, February 2009 <http://www.cbi.org.uk/pdf/20090204-CBI-R&D-Tax-Credit-survey-report.pdf>

To develop an animation tax credit similar to the R&D credit would require a substantial increase in the scope of the types of spend that would qualify (perhaps a refocusing to investment that leads to the creation of UK-owned IP), but would also need careful crafting to ensure that this expansion did not inadvertently provide funds to sectors that do not need them.

Investment fund for animation

As noted in section 7, many countries have funds that make grants or invest in TV animation, such as the CNC in France, the Canadian Television Fund and the Irish Film Board. The UK does not currently have any funds supporting TV animation (after the demise of the Wales Creative IP Fund, wound up in part because it was felt to have had an excessive focus on funding film)¹⁰⁷, though it is possible that Creative Scotland may make small grants in this area.

The UK does of course provide substantial funds for film – lottery funds invested in film are rising from £27m annually in 2010 to £43m in 2014¹⁰⁸ - so there are certainly precedents for direct investment in AV content.

Were funds to be available for similar support for animation, new processes and likely a new body would be required to administer it. However, such investment would potentially be more targeted than tax credits, and could, for instance, focus funding on productions that built on and grew the particular areas of UK competitive advantage within animation.

Quotas

The UK has little in the way of quotas that support its animation sector, by contrast to countries such as France, which specifies a given percentage of revenues that channels must be spent on original French-language production.¹⁰⁹ Similar quotas, expressed either as a percent of output, spend or revenues, could be established for those broadcasting to the UK.

While not a strict quota, the service licence for CBeebies does have an unquantified requirement that it “should invest directly in animation co-production in order to stimulate the UK animation sector”, and there is widespread appreciation amongst UK animators for the BBC’s support.

¹⁰⁷ Ian Hargreaves, *The Heart of Digital Wales: a review of creative industries for the Welsh Assembly Government*, 2010, http://culture.research.glam.ac.uk/media/files/documents/2010-07-19/Hargreaves_Review.pdf

¹⁰⁸ Guardian, British Film Institute to oversee 60% rise in movie industry lottery funding, 29 November 2010, <http://www.guardian.co.uk/film/2010/nov/29/british-film-institute-ed-vaizey>

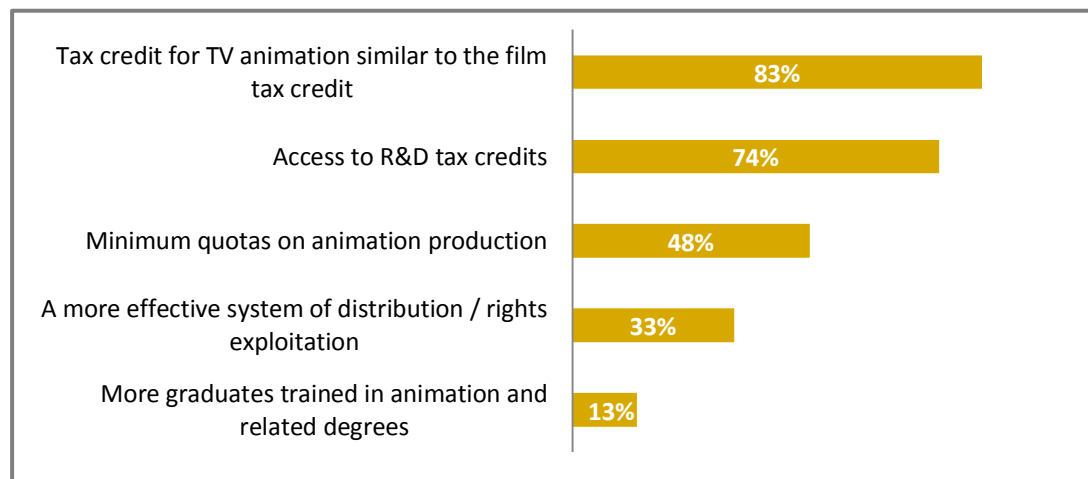
¹⁰⁹ For obligations on cable and satellite broadcasters, for example, see *Décret n° 2010-416 du 27 avril 2010 relatif à la contribution cinématographique et audiovisuelle des éditeurs de services de télévision et aux éditeurs de services de radio distribués par les réseaux n'utilisant pas des fréquences assignées par le Conseil supérieur de l'audiovisuel*, <http://www.legifrance.gouv.fr/affichTexte.do;jsessionid=?cidTexte=JORFTEXT000022145148&dateTexte=&oldAction=rechJO&categorieLien=id>

More generally, Article 16 of the EU AVMS Directive requires broadcasters to devote the majority of their transmission time¹¹⁰ to works produced (or co-produced) in Europe. However, numerous UK channels have missed this target, including several children's channels such as Cartoon Network, Cartoon Network Too, Cartoon Network Boomerang, Cartoonito, Disney Channel, Nickelodeon and Nick Jr.¹¹¹ The EC has been pushing for stricter enforcement of Article 16, which would potentially result in increased commissioning of European and (possibly) UK animation.

Industry perspective

According to our survey of UK animators, a tax credit for animation is widely believed to have the potential to make a real impact, with 83% of animators believing it would make a significant difference to them:

Figure 25: Which of the following would make a significant difference to your company?¹¹²



Conclusion

We believe the most appropriate form of government support would be a tax credit modelled on the Film Tax Credit., but with one key difference. As we have noted, some argue the Film Tax Credit has been successful in supporting a service industry in the UK but less so in developing IP-owning businesses here. While we believe this is less of a risk for animation given the starting point and the UK's strengths in animation IP development, we believe the case for government intervention is stronger if it is focused on projects where material IP is held in the UK.

¹¹⁰ Excluding news, sports events, games, advertising, teletext services and teleshopping

¹¹¹ EC, *Ninth Communication on the application of Articles 4 and 5 of Directive 89/552/EEC as amended by Directive 97/36/EC and Directive 2007/65/EC, for the period 2007-2008*, 2010
http://ec.europa.eu/danmark/documents/alle_emner/information/100923_sek-995_en.pdf

¹¹² Perspective online survey of UK animation companies

We would therefore suggest a credit that is:

- Proportional to spend in the UK (and at a similar level to the Film Tax Credit)
- Available for animated programmes intended for TV broadcast
- Restricted to projects where the recipient of the credit holds material underlying IP for the relevant characters and brands.

11. Financial analysis of a tax credit

Key points

- Tax credits clearly have a cost to the Exchequer, but this is offset by increased VAT, PAYE, NI and Corporation Tax
- Consequently we believe a Credit could in fact be moderately revenue positive to the Exchequer, even after allowing for projects that would happen in the UK with or without the credit
- This result does depend on the ability of UK animators to win additional business with a Credit, but we believe this is very plausible given the number of projects currently being co-produced with overseas partners that could be repatriated, and the experience of other countries offering credits

In this section we consider the financial trade-offs to the Exchequer in providing a tax credit. While a tax credit would clearly have a cost to the Exchequer, it would also bring substantial new revenues. A tax credit will undoubtedly help UK animators win more business (and keep more of their own projects at home, rather than sharing them with a co-producer). This will bring revenues to the Exchequer in three ways:

- **Payroll taxes.** Given the labour intensive nature of animation, more work done in the UK means greater PAYE and NIC receipts for the Treasury, either directly from employees or from the many freelancers who receive some of their income from animation
- **VAT.** Higher sales by UK animators (either to the UK or to the EU) means higher VAT receipts. Because animators' in-costs are primarily pay-roll, an increase in animation business brings substantial net VAT receipts for government
- **Corporation tax.** The initial production of animation and (at least as importantly) the downstream revenues from greater retained IP due to a tax credit will generate profit for UK animators, which in turn will provide corporation tax to the Exchequer

In analysing how this incremental receipts compare to the costs of a tax credit, we have considered five categories of animation project:

- **'Anyway' projects,** those that would take place fully in the UK with or without the credit. From the Exchequer's perspective, providing a tax credit to these is a simple loss, since there is no incremental business in the UK to offset it

- **Co-productions that stay co-pros**, projects that (with or without the tax credit) would be produced with an international partner. Again for such projects the tax credit is a simple loss for the Exchequer
- **Co-pros that become UK only**, projects that (without the tax credit) would be produced with an international partner but with the tax credit will be fully produced in the UK, generating incremental payroll and revenues from that part of the business repatriated (and associated taxes)
- **New co-productions**, new 'in-bound' co-pros where the overseas producer chooses a UK partner because of the tax credit (currently virtually unknown)
- **New full projects**, projects that occur in the UK because of the tax credit. This could be because the credit made the difference between completing the production budget or not, because the credit shortened the time to complete funding thereby enabling a company to launch projects more rapidly or (in the longer term) because greater returns from prior projects were being reinvested. Such projects give the biggest return to the Exchequer on the credit, since all the associated taxes are incremental

Note that these five categories are representative of what is of course a wider spectrum of possibilities – for simplicity we have not dealt with cases such as co-pros that continue to be joint productions, but where the UK partner wins a larger share of the work.

For the purpose of our analysis, we have developed a pro-forma animation project P&L as follows:

Figure 26 Pro-forma project P&L (£m)¹¹³

Revenue	
Initial	£3.00
Licensing	£0.90
	<hr/> £3.90
Costs	
Net salary/pension	-£1.23
PAYE/NIC	-£0.53
Other costs	-£0.95
	<hr/> -£2.70
Margin	£1.20
Corp Tax	-£0.28
Post tax margin	<hr/> £0.92

¹¹³ This and subsequent financials based on Perspective modelling

Note here that the margin represents a contribution to the overhead of the animation company in question – we have assumed this overhead is fixed in all scenarios.

Clearly in reality there will be significant variation from project to project, in scale and in the down-stream licensing revenue. Hit projects will generate much more, those that disappoint will generate none at all. However, we believe the above figures represent a plausible average. We use a modified version of this P&L for co-productions, with a portion of revenues and costs allocated to the overseas partners.

We then consider the net impact to the Exchequer of providing a tax credit to each of the five categories of project above, based on the change in PAYE, NIC, VAT and corporation tax that results:

Figure 27 Exchequer gain or loss from provision of tax credit, by project type (£m)

	<i>'Anyway' project</i>	<i>Co-pro that stays co-pro</i>	<i>Co-pro that becomes UK only</i>	<i>New co-pro</i>	<i>New full project</i>
Cost of tax credit	-£0.54	-£0.22	-£0.54	-£0.22	-£0.54
Incremental PAYE/NIC	£0.00	£0.00	£0.32	£0.21	£0.53
Incremental VAT	£0.00	£0.00	£0.26	£0.26	£0.51
Incremental Corp Tax	£0.00	£0.00	£0.08	£0.20	£0.28
	<u>-£0.54</u>	<u>-£0.22</u>	<u>£0.11</u>	<u>£0.45</u>	<u>£0.78</u>

As noted, for the 'anyway' and 'co-pros that stay co-pros' projects, the tax credit (set at 20% of production costs, in line with the Film Tax Credit) is a straight loss. Since the project would have been fully produced in the UK anyway, there is no incremental tax revenue.

Co-productions that are brought back to the UK by a credit are mildly positive for the Exchequer. The extra employment and sales generate payroll taxes and VAT respectively that more than match the credit.

Finally, new full projects and co-pros enabled by the credit provide substantial benefit to the Exchequer. The incremental taxes are more than double the value of the credit.

The next step is to consider the current number and mix of projects, and the number of new projects that a tax credit might enable. We estimate that 70% of UK projects are currently co-productions (of a total of 30). Of this 70% we assume two thirds will be 'repatriated' as a result of a tax credit

We further estimate that a credit could increase the number of UK projects by 30%, another 9 projects per year (of which one third would be new co-pros and two thirds

full projects). This obviously is a key assumption. However, simply reducing the time required to finance a project from 24 months to 18 months would accelerate the number of projects per year by 33%. Projects for which the credit made the difference between viability or not, and the benefits of greater funds to invest would all be additional. This suggests that the 30% figure is a reasonably conservative one. The scale of the global market into which the UK could grow, and the success of tax credits in other countries also provide comfort that a 30% expansion is reasonable in a short number of years.

By applying the gains to the Exchequer across this mix of projects, we get the following results:

Figure 28 Aggregate Exchequer gain/loss as a result of a tax credit

	'Anyway' project	Co-pro that stays co-pro	Co-pro that becomes UK only	New co-pro	New full project	Total
Projects (after tax credit)	9	7	14	3	6	39
Financials						
Cost of tax credit	-£4.86	-£1.51	-£7.56	-£0.65	-£3.24	-£17.82
Incremental PAYE/NIC	£0.00	£0.00	£4.42	£0.63	£3.16	£8.21
Incremental VAT	£0.00	£0.00	£3.60	£0.77	£3.09	£7.46
Incremental Corp Tax	£0.00	£0.00	£1.06	£0.60	£1.66	£3.32
	-£4.86	-£1.51	£1.53	£1.36	£4.66	£1.18

Overall, provision of tax credit provides a moderate net gain to the Exchequer, of £1.18m. Note that much of the tax credit 'investment' is in repatriated co-productions. While the Exchequer makes only a moderate gain on these projects, they are particularly low risk – they are already controlled by a UK animator, and the incentives to do production domestically will be significant.

Note that the Irish Business and Employers Confederation assess the net impact of the Section 481 tax credit in Ireland on a similar basis to that used above. For 2009 they found that the credit cost the Irish Exchequer €43.7m in foregone tax, but brought €55.5m in tax return, for a net gain of €11.8m (and the gains had been appreciably higher before the financial crisis).¹¹⁴

The analysis in this section is of course a focused and purely financial assessment of the trade-offs of a tax credit. It does not include benefits such as:

- Spill-overs to other parts of the UK creative economy such as gaming and film
- Any downstream benefits to retailing via merchandising and licensing
- The societal benefits of more UK-oriented children's programming

¹¹⁴ IBEC, *Film & Television Production in Ireland*, 2010 <http://www.irishfilmboard.ie/files/reports/AF%20Review%202010.pdf>

12. Conclusions

The UK animation industry has substantial strengths. It has a long track-record of building iconic brands that appeal globally, and it has a range of technical and craft skills second to none in the world. It is also exactly the type of business that is central to the future of the UK economy – knowledge intense, IP generating and with real export potential.

However, UK animation does not operate on a level playing field. Around the world numerous countries are now providing their own animators substantial financial support. This has already had a serious impact on the business UK animators can win, and is gradually eroding the UK's competitive skills advantage.

UK animators believe in their own strengths – they believe they can compete and win even without an exactly even playing field (in the form of UK support as substantial as that overseas). However, without any support at all, the future for UK animation looks very challenging indeed.

Conversely, with a degree of support (such as a TV animation tax credit modelled on the Film Tax Credit) UK animation producers are confident that they can bring substantial new business to the country, not least by repatriating projects that are currently co-productions with overseas partners. This additional business brings with it appreciable tax receipts, likely making a tax credit revenue-positive for the Exchequer.

Glossary

2D computer generated animation - animated figures are created and edited on a computer using 2D computer graphic software

2D drawn animation - the traditional process of animation whereby individual frames are first drawn on paper, with each drawing differing slightly from the next

3D computer generated animation - characters are digitally modelled using 3D computer software, often around a mesh or digital skeletal structure

Animation - the rapid display of a sequence of images of 2-D or 3-D artwork or model positions in order to create an illusion of movement

Animation UK – the body formed in 2010 to represent the interests of UK's animation industry. It includes leading British animations companies such as Blue-Zoo Productions, Chapman Entertainment, Nickelodeon UK, Aardman, and HIT entertainment

CGI – computer generated imagery. An image or images created or manipulated with the aid of a computer. The term is often used to refer specifically to 3D computer animation, although it is really more widely applicable.

Co-production - where an animated programme is produced jointly by two (or sometimes more) production companies in different countries

CNC – the Centre National de la Cinematographie is a French agency of the Ministry of Culture, responsible for the production and promotion of cinematic and audiovisual arts in France

Motion capture - key points on (usually) an actor are tracked so that their xyz positions are recorded over time. This data can then be used to transfer realistic movements to computer generated models.

Post production – the last stage of the film production process, where the "raw" footage is edited, special effects are added, sound dubbed and so on

Stop frame animation - an animation technique used to make a physically manipulated object appear to move on their own by moving them in small increments between individually photographed frames

Visual effects – commonly shortened to Visual F/X or VFX are the various processes by which imagery is created and/or manipulated outside the context of a live action shoot

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