

**Submission to Ofcom's Consultation on the
Review of the interaction between BBC Studios
and the BBC Public Service - Call for Evidence**

pact.

Introduction

1. Pact is the trade association which represents the commercial interests of the independent television, film, digital, children's and animation media production sector in the UK.
2. Pact works on behalf of its members to ensure the best legal, regulatory and economic environment for growth in the sector. Pact has around 500 member companies across the UK and the majority of these are SMEs (small and medium sized enterprises) with a turnover of less than £50m a year.
3. The UK independent television sector is one of the biggest in the world. UK independent television sector revenues have grown from £1.3 billion in 2005 to over £3 billion in 2019 largely driven by a growth in international sales.¹
4. The BBC and its commercial subsidiaries play an important role in the UK marketplace given the size and scale of the BBC. In 2019/20, BBC Studios won 49 new commissions from the BBC. BBC Studios sales were £1.4bn and £181m in profits.²
5. For further information, please contact Pact's Head of Policy, ✉.

¹ Pact Census Independent Production Sector Financial Census and Survey 2020, by Oliver & Ohlbaum Associates Limited

² BBC Annual Report 2020

Overview

Pact welcomes the opportunity to comment and contribute to the BBC Studios Review and offer our analysis on whether the BBC are adhering to the requirements set out by Ofcom to ensure the relationship between the licence fee funded part of the BBC and its commercial activities do not distort the market or create an unfair competitive advantage.

Market analysis of BBC Studios continues to show that it represents a considerable share of the UK production market with 30% share of the market which is larger than any individual independent.³

We take issue with some of the characterising of the market that Mediatique and other recent reviews on BBC Studios have set out in relation to the market context of BBC Studios. We outline some of the assumptions of the market context and why we consider this to be a misrepresentation in our response below.

As the regulator Ofcom must be confident that data and evidence that is provided to them via the BBC enables Ofcom to make a fully informed and rigorous decision on whether the BBC is meeting all its commercial and trading requirements. Pact and others in the market do not have the access to the information that Ofcom has to ensure BBC Studios is commercially efficient. We can only comment on the data and evidence that is publicly available and only critique the principles on which the regulator bases its own findings on BBC Studios. These do not provide explanations to Pact's questions on transfer pricing and the commercial rate of return as often evidence related to these areas are considered commercially confidential. This means that Pact must trust that the regulator has completed a thorough investigation to provide comfort to the market. Pact continues to have significant concerns on the levels of transparency and due diligence from the BBC under two particular areas:

- Commercial rate of return: our analysis shows that the BBC Board has not taken this seriously and none of the reports they commissioned look into this in any level of detail;
- Transfer pricing: it is still difficult to have any confidence in whether the prices used are appropriate and prevents BBC Studios from benefiting from a preferential pricing regime.

We wholly support the new requirements that Ofcom intends to bring forward (as set out in the BBC lines of business consultation) in order to shed light on the BBC's commercial rate of return and urge Ofcom to implement this in its entirety and subject the BBC to full scrutiny without compromising the proposals.

We also welcome Ofcom's plans to sample transfer pricing methodologies and the associated charges as part of the review into BBC Studios. But we need clarity on what bench marking will be used and whether this will be assessed consistently against the relevant benchmarks within the production. We continue to call for a fuller independent audit and review of transfer pricing arrangements that looks at the whole system.

³ Strengthening UK culture and creativity in a globalising TV marketplace, Pact commissioned report by Oliver and Ohlbaum, March 2020

Consultation Areas

Operational Separation

Exchange of Information

1.1 The BBC now publish an Operational Separation statement, and we continue to believe this is necessary for transparency on how the BBC is meeting Ofcom's specific requirements on operational separation. That said, we still believe elements of this reporting need to be improved especially on exchange of information. For example, despite suggesting ways to open up the pitching process, the BBC still refuses to publish what percentage of pitches translate to commissions. Transparency of pitches and commissions that have led from pitches are a good way to shine a light on the system and ensure informal exchanges of information are prevented.

Governance Arrangements

1.2 The BBC now also must provide information on all relevant conflict of interests to Ofcom and the steps they have taken to address them – however it is unclear why these are not published. Ofcom must publish severe conflicts of interests especially if the BBC fail to take action to address them.

1.3 It is promising that the BBC has accepted most of the NAO's recommendations to strengthen its governance of BBC Studios. This has been outlined in the most recent BBC Annual Report and the BBC Commercial Holdings Ltd Annual Report. However, there is no clarity on how they are going to achieve transparency of two of the recommended key performance indicators: *BBC Studios' performance in winning new work and creating new IP against what it expected; the size and strength of BBC Studios' content delivery pipeline.* Although the number of commissions won by BBC Studios is set out in the Annual Report, the value and worth of the different types of commissioning was omitted and no discussions were had over the fact that BBC Studios' production income had declined by £50m this year. The figure for BBC Studios Production income was £492m in last year's annual report and this year it is £442m despite a market that saw strong growth last year. Pact's production sector Census has revealed that growth is currently at year-on-year 4% growth trajectory.

Nations and Regions Operational Separation

1.4 Pact has previously called on the BBC to be clearer about its assurances over operational separation in the Nations and Regions and can see that in the latest commissioning supply report that the commissioning and production team are located in separate parts of the building, for example in Scotland. That said we think more stringent action should take place to ensure this is being adhered to.

Supply and Pricing of goods and services

2.1 We welcome that Ofcom will assess a sample of transfer pricing methodologies to ensure they are consistent with the principles set out in the Ofcom requirements. That said, we urge Ofcom to also carry out a more thorough investigation into transfer pricing given that the BBC's own commissioned review on its commercial activities published at the end of 2018 noted that there were limits to the Deloitte report on fair

trading conducted on behalf of the BBC, and limits to the amount of assurance they can take from the report.⁴ At the minimum a sample of prices and not just the methodologies should be taken – EY recommended the BBC carry out spot checks on prices to ensure they are appropriate and proportionate – to date we are not aware of this happening apart from general statements that ‘reviews’ are carried out each year on the prices – these do not confirm whether or not spot checks are made or whether the ‘review’ is carried out, what is found and then changed.

Brand Fees

- 2.2 Previously Pact had concerns over transfer pricing of brand fees. We previously pushed Ofcom to interrogate this further to confirm the proportion of revenues includes all lines of business. To date we are happy to see the BBC disclosing more detail into how it calculates the transfer pricing charge when it comes to brand use. However again we remain uncertain of the exact value of the BBC brand. It is still unclear what range is used to calculate and simply stating a percentage is unclear. Confirmation from Ofcom that this is being disclosed to them confidentially would bring comfort to the market. Furthermore, confirmation from Ofcom that they are able to interrogate any instances where the brand fee is excluded particularly under BBC Studios distribution would be welcome. Currently we note that a very flexible exclusion clause remains for the calculation of the brand fee under BBC Studios Distribution: *‘any other revenue agreed as excluded in writing between the BBC and BBC Studios from time to time. Any exclusion would be on the basis that the BBC masterbrand was not involved in securing such revenues.’*⁵
- 2.3 Furthermore, we continue to question why a certain capacity is being maintained in professional functions which remain embedded within BBC Public Service such as, HR directly linked to BBC Studios. Especially if there is a dedicated resource being provided to the BBC commercial subsidiaries. This could be an inherent indirect subsidy especially if by using these services BBC Studios is able to reduce its overall costs and improve its operating margins. The impact on achieving a ‘level playing field’ with independent producers could be even more acute in the nations where margins are arguably smaller. We believe the BBC should remove this capacity and any other staff who are embedded in BBC Public Service with a direct line to BBC Studios. These staff should be TUPEd across to BBC Studios as required and form part of its own operating costs consistent with other commercial companies.
- 2.4 We ask Ofcom again to question the efficiency and thinking behind maintaining this potential overcapacity within BBC Public Service.

Inclusion of margin equivalent in prices

- 2.5 Where the BBC cannot benchmark their prices, they set out to use a cost based approach. Their reasoning being that *‘The BBC does not have a profit or market-based cost of capital so the BBC does not consider it appropriate to include profit or a return on capital charge within these costs.’*⁶ Market benchmarking must include a

⁴ BBC Commercial Review, EY – December 2020, p107

⁵ BBC Group Trading Manual 2020

⁶ BBC Group Trading Manual 2020

contribution to the Public Service or margin when calculating the transfer prices for use of the BBC brands, and other supply of goods and services. We agree that when the BBC is trying to calculate a transfer pricing connected to a service that is not put out to the market in general, it is harder to arrive at a market price. But we continue to consider that it is unclear how Ofcom would measure the proposed cost standard for business support functions. In particular, it questioned whether this would include an overhead and a return to the Public Service or margin. Pact considers that business support functions should include a margin.

2.6 We note that despite Ofcom requiring the BBC to set out the amount paid on total transfer charges for each commercial subsidiary split by total amounts that have been paid, written off or remain unpaid it remains difficult to differentiate and understand, from their consolidated accounts, what aspects of this relate to transfer prices.⁷ Ofcom's methods of interrogation of the process continue to be crucial. We urge Ofcom to carry out a more detailed check of transfer prices. As Ofcom already conceded in its statement on the BBC's commercial trading and activities 'the information provided by the BBC under this requirement will not in itself allow us to assess compliance with the individual transfer pricing rules or published methodologies'⁸ Furthermore as we have previously mentioned a comparable commercial third parties would for confidentiality reasons have in-house lawyers, HR and IT services and we see no reason for this not to be replicated by BBC Studios.

2.7 Although the BBC's current transfer pricing methodology sets out the processes, the details of the transfer charges (such as the range of prices) are not published, therefore we are unable to scrutinise these properly. We remain of the view that an independent audit commissioned by Ofcom of the whole BBC transfer pricing system and not just the methodologies or principles is necessary. We disagree with Ofcom's statement from February 2019 in which it found the NAO's audit opinions provided by the Comptroller & Auditor General (C&AG) on the financial statements of the BBC Group and the commercial subsidiaries as one way to find assurance.⁹ As this year's Annual Report confirmed, the BBC's own Audit and Risk Committee, which is appointed by the BBC Board, 'oversaw the relationship with the NAO, including the scope of and approach to their work.'¹⁰ Furthermore all minuted meetings of this group have had Senior BBC Executives such as the BBC Chair and Director General present. This does not strike Pact as being the independent audit that is required. In fact, the design and form of scrutiny found currently chimes with the previous regime under the BBC Trust where 'in practice the Executive self-assesses a significant volume of activity' as found by Fingleton Associates at the time.¹¹ As we have previously raised, this report also found that the BBC Executive commissions audits of the Fair Trading processes (which Ofcom has identified as continuing to this day). These are control audits and are 'not capable of providing assurance to the Trust on the substance of the Executive's decision making.'¹² Again as previously mentioned

⁷ [The Commercial Holdings Ltd Annual Accounts and Report 2020](#) only set out analysis of revenue and operating profit by activity not the full transfer prices as Ofcom has required.

⁸ Ofcom Statement on BBC Trading and Commercial activities, February 2019

⁹ Ofcom Statement on BBC Trading and Commercial activities, February 2019

¹⁰ BBC Annual Report, September 2020

¹¹ Fingleton Associates, Fair Trading Report – A report for the BBC Trust, p2

¹² Fingleton Associates, Fair Trading Policy Review – A report for the BBC Trust, p19

EY have also found that there are “inherent limitations stated by Deloitte in its report which restrict the amount of assurance we can take from the audit.”

- 2.8 We understand that Ofcom intends to assess a sample of transfer pricing methodologies to ensure they are consistent with the principles set out in the requirements and they also intend to look at the associated transfer charges to establish how these goods and services are charged in practice. This is a welcome start but given the above Pact still considers an independent review should be commissioned by Ofcom to reassure the market.

Commercial rate of return

- 3.1 This is one area on which Ofcom must complete extensive work. To date the reviews that the BBC Board has commissioned with regards to a commercial review and in particular commercial rate of return have been unsatisfactory. Furthermore, the reports published by the NAO also do not offer clarity on how well the commercial subsidiaries are operating.
- 3.2 The Christopher Saul review did observe that the reporting of returns represents a mixture of dividends and other investment returns but agreed with the Public Accounts Committee view that this is still ‘opaque’ and that *‘it does not allow ready benchmarking against competitors and will be even more opaque now that Old Studios is merged with Worldwide. More clarity is needed here.’* However, Saul left any detailed analysis of the commercial rate of return out of its review and cited that this topic would *‘be addressed by the current “Commercial Effectiveness” review which the BBC is conducting in relation to the commercial subsidiaries’*
- 3.3 Pact looked forward to this review and when it was duly published at the end of 2018 it left many questions unanswered and contributed towards more confusion about how successful its commercial subsidiaries were operating. A crucial part of understanding how well Studios is performing will be to observe its commercial rate of return. It was therefore disappointing that when EY carried out the review it could only base its analysis on ‘forecasted’ returns. EY did not have access to BBC Studios’ actual margin results – EY go on to caveat their findings as ‘uncertain’ in the middle of the report but this observation does not get raised in its final set of conclusions whereby they deem BBC Studios to be operating effectively. This has duly been taken up by the BBC Board as proof that BBC Studios is commercially operating effectively.
- 3.4 Furthermore, we also note that the NAO’s report on BBC Studios outlined several findings that continue to concern Pact and its members:
- The NAO has highlighted the BBC does not report publicly on the composition of the £1.2bn target it has kept (before the merger) to apply to BBC Studios and that ‘this lack of disclosure and the measure’s unique nature make it difficult to assess the level of performance that the £1.2 bn target or the returns delivered represents.’¹³ It

¹³ BBC Studios, p13, (NAO, 2020)

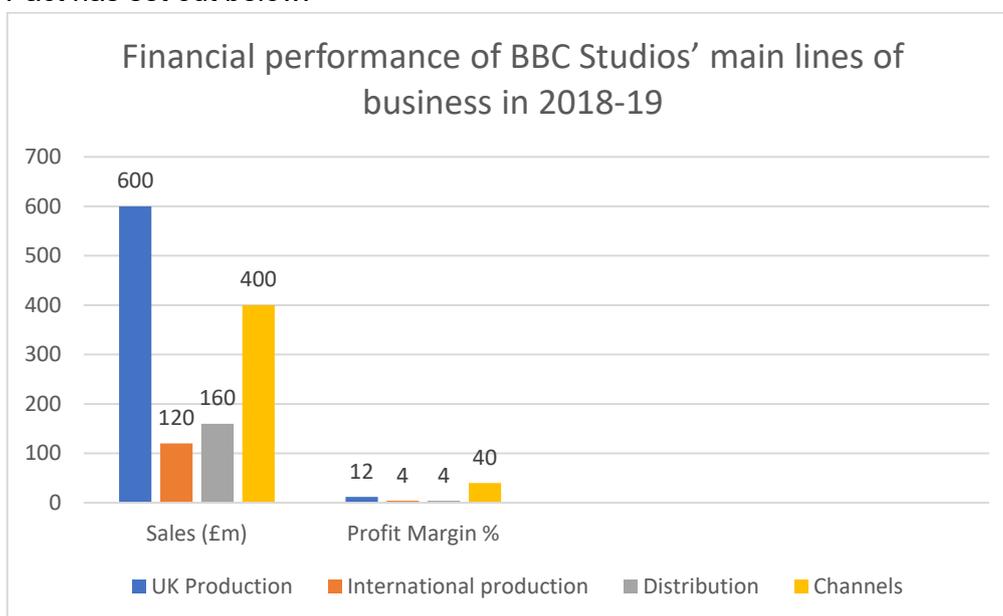
also reiterates the findings of the PAC and the independent review of the BBC commercial operations the Saul Review¹⁴ which both criticised how the BBC considers returns and that it was ‘confusing’ or ‘opaque’.

- No metrics have been set out from BBC Studios on when we expect to see results for assessing progress on the whole of BBC Studios delivering:
 - o high quality content and exploiting the associated IP,
 - o an increase in the efficiency and effectiveness of content creation and its exploitation
 - o growth by creating a business of global scale

- NAO has noted that the BBC and BBC Studios have taken several strategic decisions which help the BBC respond to market changes. These include
 - o the acquisition of ten UKTV channels from Discovery for £173m
 - o BBC’s partnership with ITV on BritBox
 - o The increased length of time programmes are available on iPlayer to 12 months

But despite the above the NAO are as yet unclear as to how these developments will impact on BBC Studios’ ability to generate commercial returns.

- In its first full year, 2018-19, BBC Studios met the overall profitability target set for it by the BBC Board, despite lower than expected sales. Beneath this top-level performance, it faces wide differences in profitability within business areas which Pact has set out below:



Source: NAO report on BBC Studios, January 2020

- BBC Studios earned £406m from existing BBC work and only generated a revenue of £28m from new commissions in 2018-19. The wide differences in profitability and the fact that Studios only returned £28m from new commissions is a reminder that

¹⁴ An independent review of the transparency of the BBC’s commercial operations (the Saul Review), commissioned by the BBC Board (January 2019)

Studios will need to be honest about profits and losses with targets set on rates of return that are consistent with the market. Unprofitability will need to be assessed closely. Since this report neither the annual report that the BBC produces, nor the BBC Commercial Holdings Ltd annual report highlight split in revenue in terms of new IP versus existing IP. Pact considers publishing the percentages of this would be useful to the market.

Wider performance indicators that inform the success of BBC Studios

3.5 Both the Saul review and the NAO's report also recommended that performance indicators should be put in place. Both financial (such as a commercial rate of return) and non-financial targets help ensure BBC Studios is performing in line with market norms and together they must inform the BBC Board in a way that makes them take decisions to the benefit of the licence fee payer. The Saul report identified that BBC Studios *'could contemplate some forward-looking disclosures around strategy and financial targets.'*¹⁵ And that this would go some way to *'to provide to internal and external stakeholders a textured feel for the merged business and its role in content creation and distribution, its financial performance, its activities in various parts of the world, its corporate governance framework, its approach to risk and its diversity and social initiatives'* Whilst the NAO recommended that the BBC should: *'Finalise the performance indicators for the regular reporting to the BBC's boards of BBC Studios' non-financial performance in early 2020 as planned, while ensuring that this set includes adequate measures to enable board monitoring of:*

- *BBC Studios' performance in winning new work and creating new IP against what it expected;*
- *the size and strength of BBC Studios' content delivery pipeline;*
- *the management of significant risks to BBC Studios achieving sustainable margins and returns; and*
- *BBC Studios' management of its staff, development of organisational capacity and delivery of cultural change.'*

3.6 It appears that the BBC has followed the above recommendations set out by the NAO and some of those set out by Christopher Saul, for example, within the BBC Commercial Holdings Ltd annual report there is a section outlining the management of significant risks but specific financial targets are not outlined. Pact is concerned that no reference is made to the fact that under Production income as a business line within the report there appears to be a £50 million decline in revenue - in 2019 the figure for BBC Studios Production income was £492m and this year it is £442m.¹⁶ We understand that businesses will offset declines in one area with other revenue streams but this is one area of particular sensitivity for BBC Studios as it has a significant advantage within the market given that it is suspected that there is a considerable

¹⁵ BBC Commercial Transparency Review- Christopher Saul

¹⁶ BBC Commercial Holdings Ltd, Annual Report and Consolidated Financial statements, September 2020 p57

advantage under the production and distribution line of business, with its extensive back catalogue of Public Service content. Ofcom rightly identifies that the BBC Studio's competitors of similar size and scope are unlikely to be able to replicate and take advantage of an equivalent back catalogue to the same extent.

Analysis of the UK production market

4.1 In the last two years there have been three reports that have considered BBC Studios and the wider market context. These include EY's BBC Commercial Review as commissioned by the BBC Board looking at the BBC's commercial activities, the National Audit Office's report on BBC Studios and lastly Mediatique's report as commissioned by Ofcom. We consider how each of these interpreted the UK production sector's market context and BBC Studios role within it. In each of these reports there have been elements of misrepresentation of the UK production market which seeks to bolster BBC Studios' position and perpetuates myths within the sector. Pact also considers that the market context outlined in these reports could skew Ofcom's decision making in terms of how it judges the BBC's actions within the market. Previous rulings on iPlayer and BritBox for example were made on the basis of Ofcom's belief that it would have minimal impact on the market. This conclusion could only be made if Ofcom continued to focus on some of the myths outlined in these reports such as, a lack of supply in the market, consolidating indies taking more share of the market, and PSBs not benefiting from the Terms of Trade. As we outline below supply in the market continues to be vibrant and dynamic with new startups entering the market each year, with ownership of IP being key towards enabling all sizes of indies to thrive in a UK commissioning market that continues to be dominated by the PSBs including the BBC.

NAO's report on BBC Studios

4.2 We were disappointed that the report failed to acknowledge the wider broadcasting ecology and how the independent production sector has played a key part in enabling the BBC to maintain quality programming despite rising costs. The report rightly highlights the increase in third party funding via co-productions but does not acknowledge the role independent producers play in identifying deficit financing for BBC programmes. It also wrongly assumes that the BBC has not owned IP rights beginning in the 1990s when in fact IP rights were only transferred after the Communications Act 2003. Finally, it sets out a narrative that assumes the change in IP ownership has been unbeneficial to the BBC.

4.3 As Ofcom already notes the Terms of Trade system, in which producers own the IP of programmes developed by their production companies, benefits Public Service Broadcasters (PSBs) like the BBC, the UK audience and producers alike. In place since 2003, the Communications Act introduced the Terms of Trade which govern the way PSBs do business with independent production companies and has been a catalyst for the sector to use their asset value to grow their businesses, secure deficit financing and drive up the quality of programming in the UK. By allowing independent producers to make use of all the IP rights it has helped drive creative competition. Independent

production companies and their enterprising nature means they are never complacent with their businesses. Independent producers use the exploitation of secondary and international rights to help secure deficit financing for programmes, which in turn allow broadcasters like the BBC to maintain quality programming for a fraction of the price. Furthermore, the BBC as a commissioning PSB broadcaster already receives a return on investment on the international exploitation of all of the content which it commissions, in perpetuity, under the Terms of Trade no matter who produces it.

EY's BBC Commercial Review report commissioned by the BBC Board

4.4 Within EY's report which set out to review the performance of the BBC's commercial activities, it set out a section which contextualised the production market. It characterised the market as being dominated by larger media groups with little plurality in supply. Although consolidation did occur significantly between 2011 and 2014 we see no signs of this being continued and we also see no signs of this consolidation having a negative impact on the UK production market. Consolidation has led to more new entrants entering the market as the favourable regulatory conditions have led executives and well respected producers to leave bigger companies to start up their own ventures – just over one third of all UK commissions are from companies with an annual turnover of less than £25m and this has been stable for the last five years.¹⁷ Therefore, EY's final analysis that '*in the context of both this global market and a declining number of independent producers, Studios provides the BBC with certainty of supply of content, and a strong production arm in a concentrated market.*'¹⁸ is again another misrepresentation of the UK production market.

Mediatique's report: State of the market in which BBC Studios operates

4.5 Finally, in Ofcom's recently commissioned report by Mediatique we take issue with the way the report has characterised the UK production market and contributed to more misrepresentation of the sector.

Super indies making up most of the revenues within the TV production sector

4.6 Mediatique acknowledge that the overall number of independent production companies has remained relatively constant over the past five years, as the effects of consolidation have been broadly offset by new company launches. But it continues to characterise the market as being dominated by the 'Super indies' or the top ten producers (including so-called 'super indies' and studio-owned production brands).¹⁹ This is despite the Pact census showing that 62% of revenues across the membership are from companies with a turnover that is less than £70m.

Reliance on deficit financing model is a threat to broadcasters

¹⁷ Based analysis from Pact Census 2020

¹⁸ BBC Commercial Review, EY – December 2020,

¹⁹ [Mediatique Report- State of the markets in which BBC Studios operates, Oct 2020, p4](#)

4.7 Mediatique do reference the fact that deficit financing is an effective form of risk sharing but its acknowledgment is understated going on to argue that a reliance on co-pros involving SVoDs will not continue. The report highlights that the model is a risk to broadcasters because it will damage their: brand recognition; prominence and ability to optimise returns in subsequent windows.²⁰ Deficit financing is not a threat to broadcasters and has enabled Public Service Broadcasters to continue the provision of high quality programming for a lower market price. Ofcom has also acknowledged this in its latest Media Nations report where it identifies that contributions to the cost of production from third parties, including as part of a co-production arrangement, deficit funding from production companies and tax credits has more than doubled over the last ten years, from £147m in 2008 to £455m in 2018.²¹ Without deficit financing, many of the PSBs' most popular programmes would simply not get produced and/or the PSBs would commission less at a higher cost to themselves. Deficit financing gives the broadcasters more freedom to commission a diverse range of content, which not only benefits them but also licence fee payers.

Consolidation inevitably going to happen and likely to be accelerated by the pandemic

4.8 Mediatique highlight that consolidation within the production sector is set to continue with very little direct evidence apart from some statements on short term weakness among smaller players and opportunistic moves by larger entities, and/or business failures. Citing the role of 'super-indies' in buying smaller companies with the aim of deeper integration of production and distribution is likely to persist.

4.9 But we are happy that it acknowledges that the regulatory conditions within the UK make it an attractive proposition for Senior Executives to spin out of larger groups to set up their own smaller entities and highlights the fact that consolidation within the UK production sector is being offset by this practice and is not necessarily a threat to the UK production sector. It is strange then that more is not made of this point and that less is made of consolidation as a result. Consolidation we argue is in fact not to be seen as a threat but an inevitable part of the UK production market which brings with it strengths including investment opportunities for the sector. This also applies to the globalised nature of the sector and the increasing importance of international ownership - again Pact does not see this as a threat to UK production sector.

BBC Studios in comparison to other integrated producer distributors

4.10 Ofcom has considered that the BBC should mirror and be held to account by comparing Studios to similar sized companies that are found in the market. Pact considers that this can only be considered in particular instances, and this overlooks the fundamental differences between BBC Studios and other companies in the market, and the many advantages that BBC Studios has had since its inception. As Ofcom rightly identifies, no other integrated entity has the equivalent back catalogue to draw on and this added advantage must not allow indirect or direct subsidy to give BBC Studios advantage over others in the market. No equivalent has output deals that the BBC has had as it began its commercial period that highlights the scale and cash that

²⁰ IBID, p45

²¹ Media Nations Report, Ofcom, 2019

BBC Studios maintains. BBC Studios as a commercial entity would have extensive financial relations with its distribution arm now that it is merged with BBC Worldwide, for example, through exclusive first-look output deals and that all IP from BBC Studio goes to its own in-house distributor, something which is not common practice in the market. Larger independent production companies who have their own distribution arm quite often use other distributors if it makes more commercial sense for the content in question. Also the biggest independent production companies that BBC Studios likes to compare itself against not only do not have the extensive back catalogue but also do not own a free to air channel such as UKTV whereby it is benefitting from ad sales and is able to directly funnel programmes onto it if needed. Although it is difficult to prove this directly it will no doubt be an advantage to Studios that it has this direct content to channel pipeline. These added advantages mean that the regulatory conditions around competition concerns need to be rigorously applied and Ofcom need to be vigilant in their monitoring of competition concerns.

Areas of concern Ofcom must act on

- 5.1 Pact continues to have concerns regarding the ability of third parties to engage with issues regarding the relationship between BBC Public Service and the BBC's commercial subsidiaries in a meaningful way. This is especially the case when it comes to understanding whether the BBC's commercial subsidiaries are operating within market norms. Despite more information being published by the BBC, there continues to be questions on the following areas below.

Ranges of transfer pricing information

- 5.2 Pact is concerned at the lack of information published on transfer pricing ranges especially where a cost approach is taken. The BBC continue to not disclose this information to third parties. Ofcom should require the BBC to disclose the range of transfer pricing charges used especially given the scale and public funding privileges it receives. Pact continues to believe that Legal and HR staff should be TUPEd over into BBC Studios. There is currently no way to understand whether BBC Group's Legal functions have positions solely dedicated to servicing BBC Studios in its entirety. If this is the case then an unfair advantage is being given to BBC Studios especially if legal costs are being procured at below market price. Again, because no range of pricing is published on this there is no way to see whether consistent market price is being utilised. Normal market practice would see a commercial entity such as the size of BBC Studios bringing legal functions in-house for confidentiality reasons.

Margins included in all transfer prices including business support services

- 5.3 Pact disagrees with Ofcom on allowing the BBC to not include a margin within their transfer charges to BBC Studios for business support goods and/or services based on costs. Market benchmarking must include a contribution to the Public Service or margin when calculating the transfer prices for use of the BBC brands, and other supply of goods and services including business support. It is unclear how Ofcom would measure the proposed cost standard for business support functions. Long term

incremental costs of these services will not include the full cost. Furthermore, we are concerned that the BBC also now have the option to set transfer prices on a fully allocated cost measure derived from the BBC's internal cost information systems. Although Ofcom consider that this cost measure would be 'verifiable' and would 'typically be expected to be above long-run incremental costs' it leaves too much discretion for the BBC to apply prices as they see fit and again risks an indirect subsidy to BBC Studios.

Independent Wholesale Review of the BBC's Transfer Pricing system

- 5.4 Pact continues to take a great interest in the possibility for an independent audit of the transfer pricing arrangements which not only focuses on controls, but the substance of decisions made by the BBC – we understand that Ofcom currently consider that the NAO's audit opinions provided by the Comptroller & Auditor General (C&AG) on the financial statements of the BBC Group and the commercial subsidiaries is one way to find assurance.²² We disagree with Ofcom on this. We again push Ofcom to commission a wholesale review of the transfer pricing system and not just whether the arrangements themselves are satisfactory and appropriate. This should be published so that third parties are made aware of any specific issues which arise and the proposed actions to address them.

Conflicts of interest and fair trading complaints

- 5.5 Ofcom must also clarify what will happen if the BBC contravenes the operational separation requirements. Ofcom note that they will be able to 'step in, if appropriate' but this does not explain how and in what circumstances they would intervene, nor what Ofcom would (beyond general terms) do if the BBC contravenes the requirements. Ofcom's role is unclear when it comes to managing conflicts of interest. Pact also continues to be unclear about how third parties should put forward their complaints regarding the BBC's requirements for ensuring fair and effective competition, particularly with regards to operational separation between UK public service and how this could affect its commercial activities. In their current guidance, there is not sufficient detail about the processes in respect to competition issues related to operational separation requirements nor how the new Fair Trading Executive committee will be part of the complaints process. Previously a fair trading complaints process was in existence and it is unclear within the current BBC complaints guidance what aspects of fair trading processes under the fair trading executive links up with the complaints process. Ofcom should investigate this and propose ways to ensure there is a clear route for third parties to be able to make complaints about fair trading processes not only through the BBC complaints process but via other means.

Failure to earn a commercial rate of return

- 5.6 Pact continues to disagree with the fact that the BBC can use any other information available to assess whether each line of business is making a return. When 'any other information' sources are mentioned what does this entail? Ofcom must check the data

²² IBID

sources used if the BBC is not using benchmarking data. The BBC must be able to interrogate and use all their resources to benchmark their activities, this is not a difficult task when many commercial companies use market and acquisition activity to predict how their company compares with other companies – to be rigorous the BBC must put in resources and efforts to meet this benchmarking. Unprofitability will need to be assessed closely. Neither the BBC annual report nor the BBC Commercial Holdings Ltd annual report highlight split in revenue in terms of new IP versus existing IP. Pact considers publishing the percentages of this would be useful to the market.

- 5.7 Although we welcome Ofcom's recognition that an 'appropriate time period' should follow relative market investor principles, this still leaves some ambiguity within the process. If Ofcom and the BBC are already able to assess what is a mature and young line of business then time periods can be set out even if it is indicative. With no boundaries or processes to set up a baseline there is a risk that the BBC has discretion to set targets that are below comparable market goals.