

Submission to Ofcom's consultation on the
BBC's commercial and trading activities:
requirements and guidance

pact.

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Introduction

1. Pact is the UK trade association which represents and promotes the commercial interests of independent feature film, television, digital, children's and animation media companies.
2. The UK independent television sector is one of the biggest in the world. Despite the uncertain climate, independent television sector revenues have grown to over £2.7 billion in 2017.¹
3. In 2017, the BBC spent £37 million on television commissions from UK external producers, this amounts to 47% of eligible television content from external producers².
4. BBC Commissions are important for independent producers as they account for 29% of all UK commissions, making the BBC the biggest buyer of content made by independent producers in the UK.³
5. Pact recognises the important role that the BBC plays in the UK television marketplace and how it nurtures and adds to the finely balanced TV production ecology in the UK. We are pleased by the positive trajectory of the new charter whereby the license fee has been secured for another 11 years. The BBC is a positive innovator and experimenter in the marketplace and this is often driven by the content which it commissions from independent production companies.

¹ Pact Census 2018

² BBC Annual Report 2017/18

³ Pact Census 2018

Overview

Pact welcomes the opportunity to contribute to Ofcom's consultation on the BBC's commercial and trading activities.

In general, we support some of the requirements that Ofcom has set out in this consultation. We are pleased to see additional robust requirements under the supply of goods and services and transfer pricing sections and endorse these requirements especially where Ofcom has outlined procedures to help Ofcom monitor the BBC's activities.

Pact welcomes the proposals especially with regards to increased scrutiny of transfer pricing.

But we are disappointed that in other areas especially with regards Ofcom requirements on commercial rate of return and transfer prices related to the supply of 'back office' functions, it appears to be a watering down of the requirements. We call on Ofcom to continue to reinstate requirements from its original framework.

We also continue to call for review of transfer pricing arrangements. Pact considers that there should be an independent audit and review into the whole system – we note that Ofcom have begun discussions with the BBC regarding this area and look forward to hearing what Ofcom and the BBC decide together on this.

Questions

Operational separation

Question 2.1: Do you agree with our proposals on operational separation including the proposed changes to the requirements and guidance? Do you agree with our proposal for a new requirement on the BBC to publish an Annual Statement on Operational Separation? Please provide reasons and evidence to support your answer.

- 2.1.1 Pact agrees with Ofcom's proposals on operational separation including the proposed changes to the requirements and guidance. It is worrying that Ofcom continues to have competition concerns about the relationship between the Public Service and the commercial subsidiaries. We agree that this relationship should be at arm's length and does not distort the market or lead to unfair competitive advantage for the BBC's commercial subsidiaries.
- 2.1.2 We particularly welcome the proposals around the annual statement that the BBC will now have to publish on its website at the same time as the publication of the annual report and accounts. This will help alleviate the limited visibility Ofcom and stakeholder like ourselves have on how the BBC is complying with operational separation requirements, as Ofcom has noted in 2.15 of the consultation report. We fully support implementing the proposed elements of the annual statement as outlined under 2.17.
- 2.1.3 We also support the proposals outlined under the exchange of information. We are happy that Ofcom recognises that given the nature of the existing requirements it may be difficult for stakeholders to have visibility of how the BBC complies with the requirements under how the BBC exchanges information. We agree that the BBC should be more clearly focused in addressing the competition concerns Ofcom have identified between the sharing of information between BBC Public Services and its commercial subsidiaries. By clearly amending the requirements to allow information sharing in specific circumstances where there is no risk to competition and by providing high-level guidance on the relevant considerations it will help with transparency of this area. The annual statement will also help to assure the market of the processes that have been put in place.
- 2.1.4 Within the high-level guidance on information sharing we do have one question regarding how the BBC may share information associated with shared services. Ofcom recognises that some Public Service employees have 'group wide' responsibilities across the BBC which cover both the Public Service and the commercial subsidiaries – we are interested in how this exchange of information would be held to account and whether the recommendations from Ofcom about ensuring the BBC considers all aspects of the information it holds in shared services would be published.

Submission to Ofcom's consultation on The BBC's commercial and trading activities: requirements and guidance

2.1.5 Under Ofcom's proposals on sharing and reporting we agree that if the BBC can show that it has reasonably determined that there is no risk to competition, then it would be permitted to share that information in those particular circumstances. We also agree with the relevant considerations outlined by Ofcom that the BBC should consider when producing a risk assessment to comply with the information exchange requirements.

Especially:

- identification of all interfaces
- Assessing what types of commercially sensitive Public Service information is available to other

However on the final area to be included in the risk assessment, we are not clear about how the BBC will determine if the information sharing is necessary to ensure the activities of the commercial subsidiaries fit with the BBC's Mission and Public Purposes. Clarity on how this will be achieved according to Ofcom would be welcome.

2.1.6 Under Ofcom's proposals at 2.47 on governance Pact questions how Ofcom will monitor the degree of influence the BBC Public Service has on its commercial subsidiary governance and decision making – with what frequency will this be conducted?

2.1.7 Pact fully supports the proposals at 2.50-2.54 to amend the conflict of interest requirements and the new reporting requirement for the BBC to provide detail of any potential or actual conflicts of interest relevant to operational separation recorded and addressed in the previous year. We are particularly happy that this will relate to all governance bodies for the Public Service and commercial subsidiaries where there are cross directorships. We also support the new requirement for the BBC to publish more information on the Commercial Holdings Board including Terms of Reference and reporting lines and relationships. It is important for us that conflicts of interests are clearly dealt with and that the process linked to cross directorships are transparent with clear oversight between the boards.

2.1.8 The report on operational separation should also include the BBC presence in the nations and regions. From a nations perspective, we welcome BBC steps to provide some level of physical separation in Scotland where BBC Studios operate from a separate unit within Pacific Quay (where access to BBC in house documents and shared files has been removed), BBC Studios in Wales is a separate unit and BBC Studios in Northern Ireland is in Blackstaff House separate to the main BBC HQ building. We welcome steps in Wales and Scotland to provide indie pass access to the buildings so that they have some access to BBC commissioners in the same building.

2.1.9 As we have previously noted, Pact has found the information on governance arrangements and exchange of information between the BBC commercial

Submission to Ofcom's consultation on The BBC's commercial and trading activities: requirements and guidance

subsidiaries and the BBC Public Service to be lacking and that current procedures do not do enough.

- 2.1.10 Pact continues to be concerned that any overlap of board membership between BBC Studios and the BBC Board – or other parts of BBC public service – presents significant risks of conflict of interest and/or privileged access to information for BBC Studios. Our preference is for no overlap of BBC Studios executives on the main BBC board. However, we recognise that BBC may not consider this practicable. Therefore, Ofcom should stipulate that most commercial directors must be separate from the BBC's public services. Furthermore, there should be a clear line of communication between the BBC Board and the Commercial Holdings Board that is objective and crucially independent. For example, oversight of the Commercial Holdings Board should also come from Non-Executives who currently sit on the main BBC Board as well as coming from BBC Executives. We want the Commercial Holdings Board to be held accountable to the Board by Executives who are not employees of the BBC or BBC Studios.
- 2.1.11 Ofcom must also clarify what will happen if the BBC contravene 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 circumstance they would intervene, nor what Ofcom would do if the BBC contravene the requirements. How will Ofcom manage conflicts of interest and who will third parties be able to talk to if they believe elements of what the BBC is required to follow have been broken?

Supply and pricing of goods and services

Question 3.1: Do you agree with our proposal that transfer prices for use of the BBC brands should be based on market prices?

- 3.1.1 We reiterate our support for the 2017 requirements on supply and pricing of goods and services. Namely, where market pricing or benchmarking is not possible the Public Service must set prices using a cost approach i.e. that costs should cover direct costs, an appropriate contribution to relevant overheads and capital costs, and an appropriate contribution for reinvestment in Public service activities.
- 3.1.2 Pact agrees with Ofcom's proposals which would expect all supply of content rights and licensing of the BBC brands to be priced at a market rate. We also agree that this should be determined by a competitive process if the BBC Brand is licensed externally, or by market benchmarking.
- 3.1.3 Market benchmarking must include overheads and a contribution to the Public Service 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

Submission to Ofcom's consultation on The BBC's commercial and trading activities: requirements and guidance

market in general, it is harder to arrive at a market price. This doesn't mean that it should be an excuse to dilute the current robust nature of the requirements which Pact consider appropriate.

3.1.4 We have further questions regarding the approach Ofcom has suggested in the consultation. We would like clarification behind the current approach set out in the consultation (based on the BBC's transfer pricing methodology manuals) where transfer pricing of brand use will be based on a proportion of the revenues that are directly linked to the use of the brands. We expect Ofcom to interrogate this further to make sure it is robust enough and that the proportion of revenues includes all lines of business, not just the revenue from direct commissions from third party broadcasters. We would also like further information from Ofcom on how the use of brands is defined – will this include use of the brand for distribution or merchandising purposes – these are all different revenue streams which will need to be considered when the correct transfer pricing charge needs to be calculated. Currently in the BBC transfer pricing methodology manuals it states that a percentage of all revenues by the BBC Studios distribution division from all its other operations beyond production will be included in the charging fee. It is unclear whether this includes distribution operations or merchandising operations, an important revenue stream when trying to work out an accurate market value of a brand. Furthermore, the BBC have several exclusion clauses that again are unclear as to why they are necessary. For example, the blanket clause which allows BBC Studios and BBC Public Service to agree from time to time more exclusions from brand fees. This is too vague a description for the market to be comfortable with. Until Ofcom is confident that the transfer prices for the BBC brand covers all possible revenue streams from BBC brand use it cannot use the proportion of revenues based on this as a reasonable proxy for the value of the use of the brands.

Question 3.2: Do you agree with our proposals that:

- a) it is appropriate to retain the ability for the BBC to set prices based on costs in the absence of market information or where benchmarking would not be proportionate; and**
- b) the calculation of cost in these circumstances should include direct costs, overheads and a contribution to the Public Service.**

3.2.1 Pact welcomes that the method for calculating costs, where there is no market benchmark, will be retained i.e. any cost-based approach covers all direct costs, relevant contribution to overhead, capital costs and an appropriate contribution for reinvestment in the public service activities – we are happy that Ofcom considers this important. We also welcome the proposals to ensure the BBC reviews the market benchmarks regularly. We note that previously in the Ernst and Young review of transfer pricing in 2016 it recommended in particular

Submission to Ofcom's consultation on The BBC's commercial and trading activities: requirements and guidance

review points for branding contracts and how brand fees are calculated given that it found BBC Global News Ltd had *'never made a royalty payment for use of the BBC brand'* and that the *'the contractual arrangements have not been reviewed in order to enable the BBC PS to recover a payment for use of the brand (for instance, by revising the royalty terms to reflect a payment based on revenue).'*⁴ Reviews of the market benchmarks will help the BBC's commercial subsidiaries to adhere to normal commercial behaviours.

- 3.2.2 It is unclear on why Ofcom has decided that the hierarchy of cost calculations where it requires the BBC to consider an open market process first is being reconsidered. Pact would consider this appropriate only if Ofcom is confident that the alternative is robust enough to ensure the BBC avoids indirect or direct state aid. This is particularly important for setting an appropriate rate for content rights.
- 3.2.3 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 Indies 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.
- 3.2.4 We ask Ofcom again to question the efficiency and thinking behind maintaining this potential overcapacity within BBC public service.

Question 3.3: Do you agree with our proposals for transfer pricing of shared business support services? Please provide reasons and evidence to support your answer.

- 3.1.1 Pact does not agree with these proposals. It is a disappointing result given that Ofcom set out to achieve a high standard of holding the BBC to account.
- 3.1.2 Long term incremental cost of these services will not include the full cost. It is unclear from these proposals what is included in the long term incremental costs and how this is calculated. If the BBC can't provide to 3rd parties and if these are services provided to BBC commercial subsidiaries at incremental cost, would this include an overhead and a return to the public service? Ofcom reference the BBC's compete or compare strategy to help calculate the costs but we are unclear as to what this is or how it is arrived at – although referenced in the BBC transfer pricing principles, there is no definitive detailed policy outlining what this

⁴ A Review of the BBC's transfer pricing regime, Ernst and Young, June 2016

Submission to Ofcom's consultation on The BBC's commercial and trading activities: requirements and guidance

entails from the BBC. We are particularly interested in how Ofcom intends to measure long term incremental costs – Ofcom's methods of interrogation of the process should be outlined in the requirements and guidance.

- 3.1.3 As previously mentioned we believe all BBC commercial subsidiaries especially BBC Studios should be TUPed across from the central group inhouse resources especially in relation to financial, legal and HR services. A commercial company of this size would have their own business support services, and this must be recognised – it would mean the BBC is on a level playing field to other competitors in the market.
- 3.1.4 There continues to be a risk of BBC commercial subsidiaries continuing to undercut the market as it can draw on group resources which normal commercial entities lack. As a result, this will give them added advantage over others when attempting to keep costs down to pitch for a show.

Commercial rate of return

Question 4.1 Do you agree with our proposals to amend the rate of return requirements and guidance? Please provide reasons and evidence to support your answer.

- 4.1.1 Pact supports most of the requirements and guidance set by Ofcom for the commercial rate of return. In particular we strongly agree with the proposed modifications to the rate of return requirements set out in 4.4 a) b) and c) of the main consultation document. Namely that a commercial rate of return applies to each subsidiary and line of business within it, that the rate of return should be earned and assessed over an appropriate time period; and that the BBC must take appropriate steps where its subsidiaries are not earning or expected to earn a commercial rate of return. Pact reiterates that commercial subsidiaries must be able to fail like any other business. Fundamentally Pact considers all BBC commercial activities must aim to generate a profit every year particularly if it is a new activity.
- 4.1.2 We also agree that if a line of business is not likely to return a commercial rate the BBC must review and must implement steps as soon as practicable.
- 4.1.3 On the modified requirement related to the BBC earning a commercial rate of return over an appropriate time period - a very specific clear reason must be put forward to Ofcom if the BBC will not return a commercial rate of return. It is unclear what Ofcom constitutes an appropriate amount of time this should be clarified. The BBC at present has a considerably mature set of business lines one of which includes BBC Studios which makes up 21% share of the market the biggest production company in the UK. We want to make sure that the BBC's commercial subsidiaries adhere to the rigor of the commercial world.
- 4.1.4 Pact disagrees with the proposal that allows the BBC to 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 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.

4.1.5 Pact also considers that the proposals set out in 4.10 should be an exception. In every case the BBC should aim to earn a commercial rate of return for every line of business and be able to measure or benchmark this within the market – it should not use the excuse that the context of the market makes this difficult. If the proposal to allow some leeway for the BBC is allowed it means it will be harder for the market to understand the viability and profitability of BBC Studios production arm. It will also mean it is harder for Ofcom to understand whether BBC Studios is returning a commercial rate of return. The BBC should always describe the costs and revenues of these lines of business no matter what the context of the market.

4.1.6 Pact would also like clarity on which part of the BBC will have responsibility to consider ceasing operations if it fails to meet a commercial return –with increased transparency of the governance structures (outlined at the start of this consultation document) this will become clearer, but clarity on who Ofcom believes should have the ultimate decision should be outlined.

Monitoring, reporting and transparency

Question 5.1 Do you agree with our proposals on the monitoring, reporting and transparency requirements? Please provide reasons and evidence to support your answer.

Separate subsidiary

5.1.1 Pact supports the proposals on the monitoring, reporting and transparency requirements for separate subsidiaries particularly for trading activity revenues the Public Service receives from trading activities with third parties, split by key categories. We would like further clarification on who will be following up on these activities and if something is found how this will be dealt with in the future.

Supply and pricing of goods and services

5.1.2 Pact agrees that the BBC transfer pricing manuals do not help with understanding the scale and value of the prices including how they change over time. Pact is particularly concerned that Ofcom finds overall that the BBC transfer pricing methodology manuals do not outline how the BBC has followed these methodologies in practice. For example, the transparency of reporting for intra-group trading to show trading within the BBC Group is lacking in transparency and the fact that because 'back office' services such as HR, legal and finance all sit within one division, as Ofcom identify, makes it difficult to

Submission to Ofcom's consultation on The BBC's commercial and trading activities: requirements and guidance

disaggregate the different kinds of services being used by the BBC's commercial subsidiaries. Finally, we are deeply worried that Ofcom have no transparency of how the actual transfer charges compare to the SLAs the BBC has put in place. Pact has previously pushed for clearer oversight of these issues with Ofcom playing a significant role to reassure the market that the BBC are abiding by the requirements. Pact agrees that Ofcom needs to monitor whether the BBC methodologies are consistent with Ofcom's pricing requirements and whether the BBC applies these methodologies in practice – historically this has often not been the case. Ernst and Young in its review of transfer pricing in 2016 found that in the previous regime it identified a number of risks and areas for improvement, including 'materiality thresholds', consistency of approaches and triggers for central referral. This meant that although the arrangements were sound the consistency of applying this in practice differed across the organisation. To alleviate this appropriate training of personnel to understand how to deal with transfer pricing issues must be maintained as per the previous regime.

5.1.3 Pact reiterates our support for the way Ofcom currently assesses information available to them to assess transfer pricing arrangements by using the following heading:

- What the BBC's chosen methodologies are;
- Whether these methodologies are followed in practice;
- Whether the methodologies used by the BBC are consistent with Ofcom's pricing requirements;

5.1.4 We also agree that there is no transparency regarding how the Public Service charges third parties for the same goods and services that it may provide to the commercial subsidiaries. We strongly agree that this information is important to understand that there is no undue discrimination between pricing approaches and to help with monitoring of the pricing requirements. We note that Ofcom have learnt at 5.41 of the consultation that the BBC is in the process of putting in place new measures for internal monitoring of individual transfer pricing transactions what will these be, and will they be published? Ofcom should ask for this to be clarified to stakeholders – how will these new measures be tested by Ofcom?

5.1.5 Pact agrees with the additional clarity it has requested regarding the BBC's transfer pricing methodologies in particular those outlined at 5.43 and 5.44 where it has asked the BBC to set out methodologies for pricing all goods and services including BBC brands which cross the boundary between the public service and its commercial subsidiaries and for the BBC to include in the pricing manual the methodologies and their impact.

5.1.6 Furthermore, we are very supportive of the proposals set out in 5.48 for additional detailed reporting requirements on transfer charges between the Public Service and the commercial subsidiaries. In addition, the push for the

BBC to provide an overview of intragroup transactions are also welcome so that the BBC outlines charges which it currently does not cover within its accounts (linked to all intragroup transactions split by categories such as transfer charges dividends and loans together with the information showing how the closing intercompany balances are arrived at from opening intercompany balances.) We also agree with points outlined at 5.56 where the BBC must decide how to best show that the transfer charges given to Ofcom are consistent with the BBC Group accounts. These actions will reassure the market that Ofcom will have adequate information to interrogate the complete picture of the transfer pricing transactions between the Public Services and the commercial subsidiaries.

- 5.1.7 Pact fully supports Ofcom's work on establishing whether the current BBC audit arrangements prove to be adequate enough to judge whether the BBC's pricing is consistent with its methodologies. Pact is particularly concerned about Ofcom's findings outlined in 5.66 of the consultation. As it stands Ofcom does not currently have a sufficient understanding of the scope of the BBC's audit arrangements to determine whether the current assurances will be enough. We 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 await how Ofcom will work with the BBC to consider options for further assurance work on transfer pricing. We draw Ofcom's attention to the 2015 BBC Trust commissioned review into the BBC's Fair Trading Policy, which although reviews the previous regime, is a handy reference point given that much of the previous regime has been replicated in the current arrangements. In that report, it 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.'⁵ As part of this we believe a wholesale review of the transfer pricing system and not just whether the arrangements themselves are satisfactory and appropriate would go some way in reassuring the market. This should be published so that third parties are made aware of any specific issues which arise and the proposed actions to address them.

Commercial Rate of Return

Target rates of return

- 5.1.8 Pact agrees overall with the proposals set under target rates of return. We fully support Ofcom's proposals at 5.81 that the BBC must provide the target rates of return for each of its commercial subsidiaries overall in addition to the current requirement to inform Ofcom of the BBC's target rates of return for each line of business within each commercial subsidiary. We also welcome under 5.82 that Ofcom will require the BBC to inform them of the target rates of return it has set for the same period as any business plans it uses for managing its businesses, including the budget for the year ahead which it currently provides. We also

⁵ Fingleton Associates, Fair Trading Policy Review – A report for the BBC Trust, p19

Submission to Ofcom's consultation on The BBC's commercial and trading activities: requirements and guidance

especially support the requirement for a definition of the metrics (e.g. EBITDA etc) used for assessing the target rates of return and reasons for selecting those metrics.

- 5.1.9 We are fully supportive of Ofcom's proposals at 5.87 and 5.88 to make the BBC publish financial performance information including a description of the activities of each line of business, (with the revenues and costs split by key categories with a description of these categories) and how the BBC demonstrates that the actual rate of return figures that it publishes aligns with its statutory accounts and primary statements within those accounts. We are also supportive of the proposals set out at 5.89 where Ofcom proposes that the BBC provide detailed financial information directly to Ofcom on budgeted figures, as well as the actuals for key categories of revenues and costs underpinning the rate of return calculations, together with the reasons for differences between actual and budgeted figures.
- 5.1.10 We also agree that this information is annually published, and that information only forwarded to Ofcom is provided biannually so long as this information is audited and that the information is easily understood by Ofcom.
- 5.1.11 Pact agrees with proposals for the BBC to provide information on target rates of return if they are below commercial level and the plans it will take to ensure a commercial rate of return including, the time period over which it is expected to happen and why the BBC considers this appropriate. It will be important for Ofcom to find out not just when it will hit the target but how it will look to reduce costs to get back to profitability.
- 5.1.12 Pact also agrees with the proposals to ensure the BBC shares information on actual rates of return that if they are below target levels the BBC have set. Reasons for this happening and the steps the BBC will take or has already undertaken to reach the target rate of return in future will be important. We continue to insist that the BBC's commercial activities must be able to fail like any other commercial business and it is able to shut operations down where appropriate.
- 5.1.13 We also agree with the proposal that if the BBC is expecting a commercial subsidiary or line of business not to earn a commercial rate of return over an appropriate time period, the BBC must notify Ofcom and provide an explanation of the steps the BBC is planning to take to address the issue. That said we would like to know what would happen in the scenario where the BBC continues to keep missing a target – will Ofcom direct the BBC to take remedial action – currently the guidance is vague on what action if any, Ofcom can take if targets continually get missed. Much of the language is provisional and non-committal. Pact insists that Ofcom carries out an investigation or directs action against the BBC if targets continually get missed. Clarity on this would be welcome.

Other issues regarding BBC commercial activities

Submission to Ofcom's consultation on The BBC's commercial and trading activities: requirements and guidance

6. We would also like to bring up the following points regarding the BBC commercial activities and the issues surrounding indirect and direct subsidy of the entities by the BBC Public Service and how to raise complaints about regulatory issues:
 - Clarity is needed on how the BBC would ensure that BBC Studios staff had access to training while avoiding cross-subsidy. Pact would expect, for example, that any training opportunities provided to Studios by the BBC public service would be made available on the same terms to external production companies. BBC Studios employees should not benefit from training opportunity from BBC public entity if they were not also available on the same terms of external production companies.
 - 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.