



SKY'S RESPONSE TO OFCOM'S CONSULTATION ON THE BBC'S COMMERCIAL AND TRADING ACTIVITIES

1. This is Sky's response to Ofcom's consultation on the "*BBC's commercial and trading activities: requirements and guidance*" (the Consultation).
2. Whilst Sky welcomes Ofcom's proposals to clarify aspects of its regulation of the BBC's commercial and trading activities, Sky remains of the view¹ that the current rules and regulations, and the changes proposed, do not allow third parties, such as Sky, to engage meaningfully on the issues which Ofcom regulates, namely the effects of the relationship between the BBC's public service and commercial activities.
3. Sky is unable to determine, for example, whether arrangements between the BBC and its commercial subsidiaries are carried out on an arm's length basis, and therefore whether the BBC's public services are obtaining value for money in way that is advantageous as compared to what the market could achieve, or whether the BBC's commercial subsidiaries are receiving a unfair benefit – the concerns set out in paragraph 4.26 of Sky's previous response remain.
4. Accordingly, Ofcom should reconsider the extent to which it requires the BBC to publish, or itself publishes BBC information (including that of its commercial subsidiaries) that would enable third parties to comment. For example, in light of the BBC's unique funding and scale, and consequently the special responsibility of its commercial subsidiaries in having privileged access to those public service resources, the following reports which Ofcom says will not be published, should be made public:
 - (a) Information on all conflicts of interest, including action taken by the BBC to address the conflict;
 - (b) Information on transfer charges;
 - (c) Information on intragroup transactions; and
 - (d) Notifications where a commercial subsidiary is not expected to earn a commercial rate of return.
5. In the absence of review by the market, Ofcom should treat with appropriate scepticism the data it receives and subject it to the fullest scrutiny, where necessary consulting industry for views on what constitutes 'normal' market practices and conducting other benchmarking exercise.

Sky

September 2019

¹ Sky expressed these views most recently in its response to Ofcom's consultations dated 28 February 2017 (extracts of which are attached as Annex 1 for convenience).

ANNEX 1

Extracts from Sky's response to Ofcom's consultations dated 28 February 2017

SECTION 4: COMMERCIAL ACTIVITIES

- 4.1 This section contains Sky's response to the Commercial Consultation.
- 4.2 As with other BBC activities, Sky both competes and collaborates with the BBC's commercial subsidiaries across a range of activities. In particular, we distribute some of the BBC's services (such as UKTV pay channels, and certain BBC content made available by BBC Worldwide) on a commercial basis, while Sky Vision competes directly with BBC Worldwide (and, in future, a newly privatised BBC Studios) in content production and distribution.
- 4.3 Ofcom's regulatory framework for the BBC's commercial services will play a critical role in ensuring that its impact on the wider market is effectively scrutinised and controlled. It is therefore essential that Ofcom's procedures and guidance in relation to such assessments are clear and robust.

Ofcom's duties in relation to commercial services

- 4.4 The new BBC Royal Charter confers a number of duties on Ofcom in relation to commercial activities, notably that in exercising its functions in relation to the commercial activities the BBC "*must ensure that its commercial activities do not, as a result of their relationship with the UK Public Services, non-service activities or trading activities, distort the market or gain an unfair competitive advantage*".²
- 4.5 Under clauses 23-27 of the Framework Agreement, Ofcom is required to set requirements in the Operating Framework to protect fair and effective competition in the UK in relation to material changes proposed by the BBC in relation to its commercial services. As with competition assessments, where the BBC publishes a proposed change, Ofcom must first determine whether this change is material. If it concludes the change is material, it must then assess whether it is likely to distort the market or create an unfair competitive advantage.
- 4.6 Furthermore, under clause 28 of the Framework Agreement, Ofcom is required to set out trading and separation requirements on the BBC to ensure that commercial activities do not distort the market or gain an unfair competitive advantage as a result of their relationship with the Public Service.
- 4.7 Specifically, these rules may include requirements to ensure that:
- (a) relationships between the BBC Public Service and the commercial subsidiaries operate at arms-length;
 - (b) commercial activities are carried out in accordance with normal market principles, including making a commercial rate of return; and
 - (c) the relationship between the BBC Public Service and the commercial subsidiaries is appropriately transparent, including providing Ofcom with financial reports and the publication of information.
- 4.8 These duties bear significant similarities to those conferred on the BBC Trust under the previous Charter. While the Trust handled only a small number of appeals on fair trading

² Article 18 of the Charter.

and commercial activities, this is largely reflective of a lack of clarity and confidence in the framework it established.

- 4.9 In particular, Sky would note the concern (identified by Fingleton Associates in its Trust commissioned review) at “*the lack of formal mechanism through which to express views on the impact of the BBC’s activity on the market*”.³ The review also noted that implementation was heavily reliant on self-assessment by the Executive and that the Trust had not conducted any “own initiative” investigations on fair trading matters.
- 4.10 Ofcom’s challenge therefore is to create a regulatory framework that is more effective in providing appropriate scrutiny and transparency of the BBC’s activities in this area than was achieved under the Trust.

Ofcom’s proposed trading and separation arrangements are not robust enough to mitigate the competition concerns it identifies

- 4.11 Section 3 of the Commercial Consultation sets out the potential competition concerns that Ofcom considers may arise over this Charter period, and the subsequent trading and separation requirements it proposes to impose on the BBC in order to protect fair and effective competition.
- 4.12 Sky agrees with the potential competition concerns Ofcom identifies - that the BBC’s commercial subsidiaries might enjoy preferential access to BBC public service assets, and that they may distort markets by offering products at a price below cost. In addition, given the significant market presence the BBC commercial subsidiaries have – in particular BBC Worldwide, the biggest content distributor outside the US studios – Ofcom should also have regard to general competition law, including state aid law, in scrutinising the BBC’s commercial activities.
- 4.13 However, Sky is concerned that, as with the previous regulatory regime, Ofcom’s proposals fall far short of measures sufficient to enable proper scrutiny of the BBC’s commercial activities and therefore provide no guarantee that the BBC is trading fairly. In particular, Sky is alarmed that Ofcom appears to broadly accept the BBC commercial subsidiaries may have non-standard relationships or interactions with the UK Public Service, and the lack of explicit guidance Ofcom provides in combatting this.
- 4.14 In summary:
- (a) *Operational separation requirements:* Ofcom should remove the proposed ‘exceptions’ in its requirements, whereby BBC subsidiaries would be permitted to share information and employees with the UK Public Service.
 - (b) *Supply of goods and services requirements:* Ofcom should require the BBC Public Services to adopt a market-based approach as standard to its goods and services, only contracting with BBC subsidiaries if they are successful in a competitive open market process.
 - (c) *Transfer pricing requirements:* Absent a market-based approach, Sky is concerned that the BBC will seek to rely excessively on a cost-based approach to transfer pricing. Ofcom should only permit this where the BBC can actively demonstrate that the supply of goods and services would be expected to be priced effectively at cost even in an open market.
- 4.15 We expand on these concerns below.

³ *Fair Trading Policy Review*, Fingleton Associates, p.3. Available at: http://www.fingletonassociates.com/wp-content/uploads/2015/07/FingletonAssociates_BBCTrustFairTradingPolicyReview_July2015.pdf.

Operational separation requirements

- 4.16 Ofcom proposes operational separation requirements in relation to two broad activities – the exchange of information between the BBC’s public services and its commercial subsidiaries, and governance arrangements of the commercial subsidiaries. In both cases, Sky is concerned that the ‘exceptions’ Ofcom allows for in these requirements risk rendering regulation in this area ineffective.
- 4.17 First, Ofcom proposes that the BBC must ensure that commercial subsidiaries do not “normally” have access to information relating to the UK public services that is not available to the wider market. It goes on to state that, where this does occur, the BBC must put in place mechanisms to ensure that such information is only used “for the specific purpose for which it was obtained”.⁴
- 4.18 No guidance is given by Ofcom as to the ‘abnormal’ circumstances under which the commercial subsidiaries would be permitted access to such information, beyond a very wide description of ensuring that “*the activities of the BBC’s commercial subsidiaries fit with the Mission and Public Purposes*” or in relation to “*the fulfilment of any existing commercial relationship*”. Moreover, Ofcom does not indicate what mechanisms would in its view be appropriate in ensuring the information was only used for a specific purpose.
- 4.19 Second, Ofcom’s requirements on governance appear strong in the first instance – with commercial subsidiaries required to be run by Directors who are “*distinct and separate from the BBC Board and its executive committee*”. But this requirement is undermined by subsequent wide exceptions. In particular, Ofcom specifically allows for Directors to serve on the board of a BBC public service *and* a commercial subsidiary, so long as “*appropriate measures*” are in place to identify, record and address any conflicts of interest.⁵ Again, Ofcom provides no indication as to the kind of measures it would view as appropriate.
- 4.20 These requirements do not in themselves give Sky confidence that the BBC’s commercial activities will be conducted at arm’s length from publicly funded services. The exceptions Ofcom envisage would, in reality, allow for little to no separation at all between the BBC Public Service and its commercial subsidiaries.
- 4.21 In order to be more robust, Ofcom’s requirements should be far more definitive. It should remove the exceptions it allows in both exchanges of information and governance arrangements – for example, with an amended list of requirements such as:
- (a) “The BBC must ensure that commercial subsidiaries do not ~~normally~~ have access to information about the BBC Public Service’s strategy, priorities and activities that is not available to the wider market, other than ~~that strictly required to ensure the activities of the BBC’s commercial subsidiaries fit with the Mission and Public Purposes~~ or for the fulfilment of any existing commercial relationship.”
 - (b) “The BBC must ensure that BBC commercial subsidiaries are run by boards and executive committees of Directors which are distinct and separate from the BBC Board and its executive committees. ~~They should also consist of an appropriate number of directors with an emphasis on those who are separate from the BBC Board and its executive committees.~~”

⁴ Paragraph 3.21 of the Commercial Consultation.

⁵ Paragraph 3.24 of the Commercial Consultation.

Supply of goods and services requirements

- 4.22 Sky supports Ofcom's proposals to require the BBC to ensure that any arrangements entered into between the BBC Public Service and commercial subsidiaries are made on arm's length commercial terms. Such an approach is clearly necessary in order to guard against potential competition concerns arising.
- 4.23 Ofcom also requires that the BBC Public Service make its assets available to third parties on equivalent terms and prices to those offered to its commercial subsidiaries. However, this requirement only applies in instances where the BBC Public Service actually supplies these assets to the wider market, with Ofcom appearing to give the BBC complete discretion in this regard. Under the proposed requirements, it would appear to be perfectly permissible for the BBC to *never* supply Public Service goods and assets to the wider market, so long as it had arrangements in place to ensure that direct relationships between the Public Service and commercial subsidiaries could be said to be conducted on an arm's length basis.
- 4.24 Sky is concerned that such a permissive approach may embed existing practices that threaten an adverse impact on fair and effective competition, as well as acting against licence fee payers' interests more generally.
- 4.25 The BBC Public Service already enters into a number of arrangements with its commercial subsidiaries. Most notably, BBC Worldwide has a 'first-look' agreement, under which it receives first refusal to invest in the majority of co-production deals the BBC's public service enters into. Arrangements such as this prevent a competitive market emerging for BBC assets, despite other players being active in this part of the value chain.
- 4.26 Sky has long-standing concerns with regard to the preferred partnership between the BBC and BBC Worldwide. These include:
- (a) Whether BBC Worldwide is incentivised to maximise the exploitation of BBC content. In particular, Sky notes that BBC Worldwide is able to 'warehouse' rights acquired from the BBC rather than exploit them, with no condition that rights must be exploited when the BBC transacts with BBC Worldwide.
 - (b) Whether BBC Worldwide's exclusivity results in inefficiencies and distortion of competition through licensing policies and agreements. [X]
 - (c) Whether the BBC – and by extension the licence fee payer – is missing out on important revenue streams as a result of these practices.
 - (d) An ongoing lack of transparency as to the relationships between the BBC and BBC Worldwide.
 - (e) Preferential treatment of BBC Worldwide through discriminatory cross-promotion of BBC Worldwide services from public services, for example BBC Store's prominence and promotion within BBC iPlayer. We provide examples of this in Annex 2.
- 4.27 So long as a preferential agreement between the BBC and BBC Worldwide remains (and other market players are unable to present counter offers), these concerns are likely to persist.
- 4.28 In Sky's view, therefore, the presumptive approach for all BBC activities that require interaction with commercial players (whether subsidiaries or otherwise) should instead be one of market competition. Greater competition drives efficiency, value for money and better on screen outcomes, as well as strengthening the wider UK content sector by

providing further growth opportunities for other market players. It is also the only way to truly test the market in terms of prices and terms and conditions, and is therefore crucial in providing relevant benchmarks for transfer pricing (see below).

- 4.29 Ofcom should amend its proposed requirements to ensure that in the first instance the BBC makes all public service goods and services available to wider market as standard. For example:
- (a) "Goods and services supplied by the BBC Public Service should be sold on the open market by being made available to third parties on equivalent terms and prices to those offered to its commercial subsidiaries."
 - (b) "Where the BBC Public Service provides goods and services solely to its commercial subsidiaries, the BBC must ensure that arrangements are made on arm's length commercial terms."
- 4.30 Implementing a transparent market-based approach as standard which provides competitors with the opportunity to participate in the market would be critical step in ensuring that the BBC's commercial trading processes are adequate.

Transfer pricing requirements

- 4.31 Ofcom proposes a number of requirements in relation to transfer pricing. The BBC is required to set prices for goods and services "*as if they were sold on the open market*", using prevailing market practices as benchmarks "*wherever possible*".⁶ Cost-based approaches to pricing are permitted if the BBC can demonstrate that no relevant market benchmarks are available.
- 4.32 Sky supports Ofcom's clear preference for benchmarking, which is the most effective way for an organisation to gauge an appropriate transfer price. This is particularly true in the broadcasting sector since the value of rights may differ significantly by purchaser.
- 4.33 As noted above, Sky considers that one benefit of subjecting more of the BBC's supply activities to open bidding processes would be that this would establish clear and verifiable market benchmarks for subsequent transfer prices to be based on. Adoption of an open market approach across the BBC's activities would enable the BBC to undertake benchmarking in the vast majority of cases.
- 4.34 Without the comprehensive benchmarking that a market based approach allows, the danger is that the BBC seeks to rely more usually on a cost-based approach. Such an approach risks undervaluing significantly the benefit to the BBC's commercial subsidiaries, as it bears no relation to what those services would have to pay in the market. As noted, this is particularly relevant to content rights which may be valued very differently by different players.
- 4.35 Under Ofcom's proposals, the BBC is required to adopt a cost-based approach only where it can demonstrate that no market benchmarks are available. So long as the BBC retains discretion over which of its Public Service goods and services are made available on the open market, this could become something of a self-fulfilling prophecy – no benchmarks are available (and therefore a cost-based approach is permitted) precisely because the BBC opts to strike an agreement with its commercial subsidiaries without inviting other offers. This raises a clear risk of adversely impacting on fair and effective competition, and emphasises again the criticality in ensuring a market based approach is followed as standard.

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Paragraph 3.33 of the Commercial Consultation.

- 4.36 Consequently, it is not sufficient for the BBC merely to demonstrate that no benchmarks are available. Ofcom should only permit a cost-based approach to pricing where the BBC can actively demonstrate that the supply of goods and services would be expected to be priced effectively at cost even in an open market. This may for example be the case where the BBC Public Service offers goods and services that are widely available from other providers.
- 4.37 Sky also has an ongoing concern with the general lack of transparency in relation to transfer pricing and valuation. In our experience we have little information or understanding as to the approach taken by the BBC Executive, resulting in an inability to challenge assessments or make alternative offers. This is particularly the case in terms of payments made by BBC Worldwide for use of the BBC brand.
- 4.38 In this context, Sky supports Ofcom's later requirements to publish the methodologies the BBC uses to establish transfer prices and to value the BBC brands.

Ofcom's assessment of material changes to commercial activities

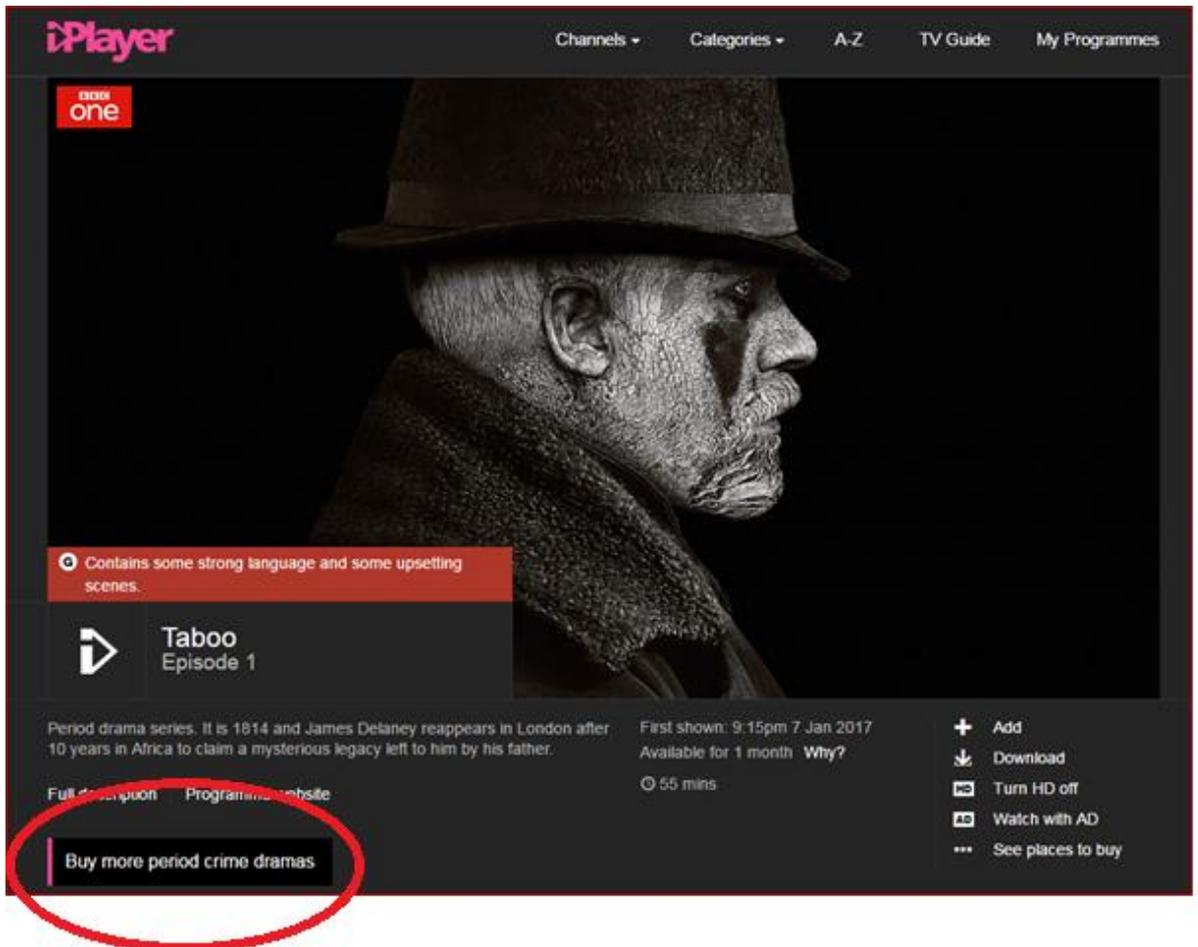
- 4.39 Sky broadly supports Ofcom's proposed approach to *ex ante* assessments of material changes to BBC commercial activities.
- 4.40 Ofcom's suggested process bears similarities to its proposed competition assessment process. Many of Sky's comments outlined above also therefore apply in this case, including:
- (a) *BBC materiality assessment*: Ofcom should go further and provide for the BBC to take a precautionary approach to its materiality assessment, and limit the use of trials to allow for proper consideration of their impact;
 - (b) *Appropriate assessment procedure*: Ofcom should minimise its reliance on the BBC's assessment, should adopt a presumption that any change deemed as material will be assessed under a full trading and separation assessment, rather than any shorter assessment. This is necessary given BBC incentives to reach a positive conclusion, this may encourage 'waiving through' of changes without proper scrutiny or investigation, particularly in relation to new services.
 - (c) *Transitional arrangements*: It is essential that no material changes to the BBC's commercial services are permitted to pass during the current transitional period. For example, BBC Worldwide and ITV have launched Britbox, an OTT pay TV service, in the US. Sky understands that the BBC Trust is currently considering proposals to launch the service in the UK. Given the new procedures and obligations set out in the Charter and Agreement providing increased scrutiny over such commercial services, it would be of significant concern were the Trust to authorise a new commercial service before Ofcom takes over regulatory responsibility. Such a matter would appear to fall squarely within Paragraph 2(2) of the Schedule to the Charter covering transitional arrangements as a function that the Trust ought to refrain from exercising on the ground that it would be more appropriate for the Board to deal with the matter in question on or after 3 April 2017.

ANNEX 1: SKY'S RELATIONSHIP WITH THE BBC

[REDACTED]

ANNEX 2: EXAMPLE OF PREFERENTIAL TREATMENT OF BBCWW (BBC STORE/IPLAYER)

1. [Public service content location with "Buy more period crime dramas" promotion:](#)



2. [Link through from "Buy more period crime drama"](#)

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