

## Annex 2. Trading and separation requirements

A2.1 In this document we set out our proposed modified requirements and guidance against the existing requirements. Green text denotes new text and black text denotes existing text. We do not show any formatting changes in this document. We have not included Part 3: Reporting templates in this Annex.

### Schedule

#### Part 1: Definitions and Interpretation

1. In this Schedule -

“Agreement” means the Agreement Between Her Majesty’s Secretary of State for Culture, Media and Sport and the British Broadcasting Corporation, dated December 2016;

“BBC Annual Report” means the annual report which is published each Financial Year pursuant to Article 37 of the Charter and which includes the statutory financial statements required by the Companies Act 2006;

“BBC Group” means the British Broadcasting Corporation and each Relevant Subsidiary as defined in clause 75 of the Agreement;

“Budgeted Figures” means the numbers as per the BBC’s budgets and/or business plans which are used by the BBC in calculating the Target Rates of Return;

“Charter” means the Royal Charter for the Continuance of the British Broadcasting Corporation, dated December 2016;

“Commercial Subsidiaries” means one or more of the Relevant Subsidiaries as defined in clause 75 of the Agreement and currently includes: (i) BBC Studios which incorporates BBC Studios Limited and BBC Worldwide Limited; (ii) BBC Studioworks Limited; and (iii) BBC Global News Limited;

“Commissioning Requirements” means the requirements contained in paragraph 7 of Schedule 3 of the Agreement;

“Contracted Amounts” means, for the purposes of Requirement D.7(b), the amounts of Transfer Charges agreed as part of the service level agreements or the BBC’s budgeting process between the Public Service and any of its Commercial Subsidiaries before the relevant goods and/or services are provided;

“Enforcement Procedures” means Ofcom’s “Procedures for enforcement of BBC competition requirements” as published on 28 June 2017<sup>1</sup>;

“Financial Year” means 1 April to 31 March;

“Joint Venture” means a company in which one or more Commercial Subsidiaries hold a material shareholding as a Commercial Activity but which is not a Relevant Subsidiary;

“Operational Separation Statement” means a statement published pursuant to Requirement D.2;

“Pricing Methodology Manual” means a manual published pursuant to Requirement D.5;

“Public Service” means the BBC’s UK Public Services, Trading Activities and Non-service Activities;

“Requirements” means the requirements set out in Part 2 of this Schedule;

“Target Rates of Return” means, for the purposes of Requirements D.10 to D.12, the rates of return which the BBC sets prior to the start of each Financial Year to achieve rates of return in that Financial Year, and in any future Financial Years;

“Transfer Charges” means, for the purposes of Requirements D.5 to D.8, the total amounts charged for any transaction or group of transactions between the Public Service and the Commercial Subsidiaries and includes by way of example the total rent charged for all properties used during a Financial Year; and

“Transfer Prices” means, for the purposes of Requirement D.5, the unit prices charged between the Public Service and the Commercial Subsidiaries and includes by way of example the rent charged for a specific property for the relevant period.

2. Except in so far as the context otherwise requires:
  - a) words or expressions shall have the meaning assigned to them in paragraph 1 of Part 1 of this Schedule, and otherwise any word or expression shall have the same meaning as it has in the Charter and/or the Agreement; and
  - b) words in the singular shall include the plural and, in the plural, shall include the singular.
3. A reference to a statute or statutory provision is a reference to it as amended, extended or re-enacted from time to time.
4. The Interpretation Act 1978 (c. 30) shall apply as if this Schedule were an Act of Parliament.
5. Headings and titles shall be disregarded.

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<sup>1</sup> The Enforcement Procedures are available at:  
[https://www.ofcom.org.uk/data/assets/pdf\\_file/0010/102520/Procedures-for-enforcement-of-BBC-competition-requirements.pdf](https://www.ofcom.org.uk/data/assets/pdf_file/0010/102520/Procedures-for-enforcement-of-BBC-competition-requirements.pdf)

6. Expressions which cognate with those referred to in this Schedule shall be construed accordingly.

## Separate subsidiary

The BBC must:

- not directly undertake any commercial activities. All commercial activities must be undertaken through commercial subsidiaries.

3.22 — In line with the Charter and Agreement<sup>2</sup>, the BBC must not directly undertake any commercial activities. Any commercial activities must be undertaken by its commercial subsidiaries.

3.23 — If the relationship between the BBC Public Service and the commercial subsidiaries is to be transparent and to operate at arm's length, there needs to be clear separation between the two.

3.24 — However, a clear separation is not sufficient to eliminate all our potential competition concerns. For example, the BBC Public Service may provide the commercial subsidiaries with goods or services at below market price, or the commercial subsidiaries may not act in accordance with normal market principles. This may lead to market distortion if commercial competitors do not have access on the same terms to assets that are made available to the market. There is therefore a need to go further than just relying on separation of commercial subsidiaries in order to address our competition concerns, and we are requiring a range of additional measures detailed below.

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<sup>2</sup>Clause 23 (4) of the Agreement sets out that: "The BBC as a corporation must not directly undertake any commercial activities and they must be provided through one or more commercial subsidiaries."

## Part 2: Requirements and Guidance

### A. Separate subsidiary and ~~o~~Operational separation requirements

#### Requirements

- A.1 The BBC must not directly undertake any Commercial Activities. All Commercial Activities must be undertaken through Commercial Subsidiaries at arm's length from the Public Service and on commercial terms.
- A.2 The BBC must have in place appropriate measures, controls and processes to eEnsure that its Commercial Subsidiaries and Joint Ventures do not have access to information about the BBC Public Service's strategy, priorities and activities that is not available to the wider market third parties, 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.~~
- a) information that is necessary to ensure that the Commercial Activities fit with the BBC's Mission and Public Purposes; or
  - b) information that is necessary for the fulfilment of any ~~existing commercial relationship contract; or~~
  - c) information, that if shared, does not carry any risk that Commercial Subsidiaries or Joint Ventures could, as a result of having access to that information, distort the market or gain an unfair competitive advantage.
- A.3 The BBC must have in place appropriate measures, controls and processes ~~Where the commercial subsidiaries do have access to information about the strategy, priorities and activities of the BBC Public Service that is not available to the wider market, put in place mechanisms to ensure that the information~~ falling within Requirements A.2(a) and A.2(b) is only used for the specific purpose for which it was obtained.
- A.4 ~~Ensure that BBC~~ The Commercial Subsidiaries must be ~~are~~ run by boards and executive committees of directors which are distinct and separate from the BBC Board and its executive committees. ~~The~~ se boards and executive committees must ~~should~~ also consist of an appropriate number of directors ~~with an emphasis on those who are~~ not members of ~~separate from the BBC Board and/or its executive committees.~~
- A.5 The BBC must have ~~Put~~ in place appropriate measures, controls and processes to ensure that where a director serves on the board and/or executive committee of both the BBC Public Service and a Commercial Subsidiary or Joint Venture, any potential conflicts of interest are identified, recorded and addressed.

## Guidance

### Exchange of information

- A.6 The relationship between the BBC Public Service and the Commercial Subsidiaries or Joint Ventures creates a risk may lead to concerns that the Commercial Subsidiaries and Joint Ventures obtain could be privy to information which gives them an unfair competitive advantage or distorts the market. The purpose of Requirements A.1 to A.3 is to ensure that this risk is addressed. For example, where the BBC is tendering for a service that one of its commercial subsidiaries could supply, the BBC may, deliberately or inadvertently, provide the commercial subsidiary with information that would result in an unfair advantage in the process.
- A.7 Equally, some exchange of information will be necessary, for example in the course of fulfilling a commercial agreement. In order to comply with Requirements A.1 to A.3, we expect the BBC to carry out an ongoing and comprehensive risk assessment to identify areas which present a risk of an unfair competitive advantage or market distortion, and to implement measures, controls and processes to ensure that information flows are managed as necessary. This risk assessment should be reviewed regularly and include, as a minimum, the following:
- a) an identification of all interfaces between the Public Service and Commercial Subsidiaries and/or Joint Ventures where information is, or could be, shared;
  - b) an assessment of what types of commercially sensitive Public Service information, which is not available to third parties, could put the Commercial Subsidiaries and/or Joint Ventures at an unfair competitive advantage or lead to market distortion; and
  - c) a determination of whether the information sharing is necessary to ensure that the activities of the Commercial Subsidiaries and/or Joint Ventures fit with the BBC's Mission and Public Purposes or for the fulfilment of a contract.
- A.8 Therefore, the BBC Public Service must ensure that the commercial subsidiaries do not 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 Public Service's Mission and Public Purposes or for the fulfilment of any existing commercial relationship. Where measures, controls and processes are necessary to manage information flows in accordance with these Requirements, we expect these to include the following:
- a) training of staff and internal guidance;
  - b) appropriate arrangements for co-located employees;
  - c) IT system controls;
  - d) conflicts of interest procedures; and
  - e) internal compliance checks of the BBC's risk assessment and the measures, controls and processes in place to manage information sharing risks.

- A.9 ~~Where the commercial subsidiaries do have access to information about the BBC's strategy, priorities and activities that is not available to the wider market, the BBC must be able to justify why such an exclusive or preferential arrangement with the commercial subsidiaries was necessary, and must put in place mechanisms to ensure that the information is only used for the specific purpose for which it was obtained.~~ An example of an area where information sharing could result in an unfair competitive advantage or market distortion is programme commissioning by the Public Service.<sup>3</sup> If BBC Studios has access to commercially sensitive information regarding the commissioning strategies and needs of the Public Service in advance of independent producers, it may be in a better position to prepare and submit tailored ideas and pitches and win commissions. Examples of commercially sensitive information that could raise competition concerns include advance notice of plans to commission large amounts of programmes on a particular theme, and changes to genre strategies or specific decisions in relation to recommissioning of existing programmes. Further examples of areas where information sharing could result in an unfair competitive advantage or market distortion relate to content distribution and sales, and audience research and performance measures.
- A.10 Some information may need to be shared to ensure that the Commercial Activities fit with the BBC's Mission and Public Purposes, and this is permitted pursuant to Requirement A.2(a). An example of an area that may fall within this exception is news production. BBC News and BBC Global News may need to share information to ensure that the output of BBC World News<sup>4</sup> fits with the BBC's Mission and Public Purposes, which includes the provision of impartial news and information and reflecting the UK, its culture and values to the world.
- A.11 Pursuant to Requirement A.2(b), information may be shared if it is necessary for the fulfillment of a contract. For example, this exception would be likely to apply if BBC Studioworks has entered into a contract to provide studio space for live productions produced by the Public Service.
- A.12 As set out in Requirement A.2(c), there may be categories of information that carry no risk of market distortion or an unfair competitive advantage if shared between the Public Service and Commercial Subsidiaries or Joint Ventures. These may include, for example, administrative information associated with shared business support functions, such as payroll administration information.

### Governance arrangements

- A.13 ~~In order~~ The purpose of Requirements A.4 and A.5 is to ensure that the governance of the Commercial Subsidiaries is consistent with an arm's length relationship with the Public Service, and that Commercial Subsidiaries are independent in objective setting, strategy and decision making, they must be run by boards and executive committees that are distinct and separate from the governance of the BBC Public Service, and consist of an

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<sup>3</sup> The BBC is also required to comply with the Commissioning Requirements, including the requirement to commission on a fair, reasonable, non-discriminatory and transparent basis.

<sup>4</sup> The commercial news channel that is broadcast outside the UK.

appropriate number of directors with an emphasis on those who are separate from the BBC Board and its executive committees.<sup>5</sup>

- A.14 We recognise that it may be appropriate for a Director to serve on both the BBC Board and the board of a commercial subsidiary. For example, the BBC may have legitimate concerns regarding the financial performance of the commercial subsidiaries and the resulting returns to the BBC Public Service, or may wish to ensure protection of the BBC Brand. Where this is the case, the BBC must put in place appropriate measures to ensure that any potential conflicts of interest are identified, recorded and addressed. It is for the BBC Board to decide how to structure the boards and executive committees of the Commercial Subsidiaries in a way that complies with Requirement A.4. In assessing the BBC's compliance with Requirement A.4, we will focus on:
- a) the balance between non-executive and executive directors;
  - b) whether the chair is independent;
  - c) the extent of overlap in membership between the boards or executive committees of the relevant Commercial Subsidiary and the BBC Board and Public Service executive committees; and
  - d) the degree of influence that the Public Service has on governance and decision making within the relevant Commercial Subsidiary.

#### Reporting requirements for Section A

- A.15 We also gather information on how the BBC is complying with Requirements A.1 to A.5 inclusive through separate monitoring, reporting and transparency requirements. These are set out in Section D of the Requirements, Requirements D.1 to D.4.

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<sup>5</sup> The duties of directors of any subsidiary company will be as set out in sections 170 to 177 of the Companies Act 2006, including acting in the interests of the company and avoiding conflicts of interest.

## **B. Supply and pricing of goods and services**

### **Requirements**

- B.1 ~~The BBC must~~ Where the BBC Public Service provides goods and/or services to the Commercial Subsidiaries or Joint Ventures, it must ensure that this takes place ~~arrangements are made on~~ at arm's length from the Public Service and on commercial terms.
- B.2 Where the BBC Public Service supplies goods and/or services to ~~the wider market~~ third parties, the BBC must not discriminate unduly as to terms<sup>6</sup> and prices:
- ~~a) make these available to third parties on equivalent terms and prices to those offered to its commercial subsidiaries.~~
  - a) not discriminate unduly against third parties when such goods and/or services are supplied to third parties and the Commercial Subsidiaries or Joint Ventures; and
  - b) ~~or~~ between different third parties.
- B.3 Subject to the exceptions set out in Requirements B.4 and B.7 below, the BBC must set prices and terms for goods and/or services supplied by the BBC Public Service, ~~whether sold to the BBC's Commercial Subsidiaries, Joint Ventures or to~~ third parties, on the basis of the following principles:
- a) Set market prices and terms for goods and/or services, ~~where appropriate using an open market process (e.g. competitive tendering),~~ or appropriate market benchmarks.  
~~Absent an open market process, set market prices and terms using verifiable, comparable information on prevailing market practices wherever possible.~~  
~~Where there are no relevant market benchmarks or evidence on market practices, adopt a cost-based approach.~~
  - b) ~~Where a cost-based approach to transfer pricing is used~~ In the absence of market information as referred to in Requirement B.3(a), or where it is disproportionate to undertake specific benchmarking exercises, set prices for goods and/or services using cost as a proxy for market prices. The BBC must ensure the that such prices covers:
    - (i) cover a All relevant direct, long-run costs involved in providing the good(s) and/or services; and include a An appropriate contribution to the relevant overheads and capital costs incurred by the business areas together with an appropriate contribution for reinvestment in the BBC Public Service activities; or
    - (ii) are only based on the BBC's long-run incremental costs of providing a good and/or service where the BBC can demonstrate that long-run incremental cost pricing conforms to market practice.

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<sup>6</sup> All references in the Requirements and Guidance in Section B to "terms" are to be read as "terms and conditions".

- c) ~~The BBC must Base prices on the BBC's incremental costs of providing a good or service only where it can be demonstrated that incremental cost pricing conforms to market practice and not set prices below short-run incremental cost under any circumstances.~~
- B.4 Requirement B.3 does not apply to business support goods and/or services which the Public Service only shares with the Commercial Subsidiaries. For such business support goods and/or services the BBC may set prices based on long-run costs of provision of those goods and/or services.
- B.5 Where the Commercial Subsidiaries supply goods and/or services to the Public Service, the BBC must set prices and terms for those goods and/or services so as to ensure that they do not exceed market prices or appropriate market benchmarks.
- B.6 The BBC must eEnsure that:
- a) any pricing methodologies and terms ~~and conditions~~ are reviewed regularly, and consistent approaches are applied to any similar goods and services, including agreements for use of the BBC ~~b~~Brands; and
  - b) market benchmarks are relevant, verifiable and reviewed regularly in line with market practice.
- B.7 ~~These r~~Requirements B.1 to B.6 inclusive do not apply to pricing of tickets for the events referred to in clause 49(4)(h) of the Agreement ("The Proms, Proms in the Park, Cardiff Singer of the Year, Young Musician of the Year; and other similar events which contribute to the BBC's Mission and Public Purposes").

## Guidance

### Supply of goods and services by the Public Service

~~The BBC Public Service uses the licence fee to fund a range of services, including content which may also have value in secondary/overseas markets. While the BBC Public Service may not directly commercially exploit these assets, it can generate income to supplement the licence fee by selling them to the commercial subsidiaries and other third parties for commercial exploitation. The commercial subsidiaries can then generate additional income which further supplements the licence fee.~~

In addition, the BBC Public Service may, in the interests of efficiency, choose to provide other goods and services to the commercial subsidiaries and other third parties. For example, the BBC may wish to provide a single HR or IT system for both the BBC Public Service and the commercial subsidiaries in order to maximise economies of scale, or provide an external producer with access to facilities and staff to support programme making for an appropriate charge.

~~The goods and services supplied to the commercial subsidiaries and third parties can be broadly categorised as, but not limited to, the following<sup>7</sup>:~~

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<sup>7</sup> See also the specified list of trading activities, as set out in Annex 1.

- a) ~~intellectual property rights – for example, selling commercial rights to BBC programmes or selling licences to use BBC-owned technology;~~
- b) ~~facilities – for example, hiring out of BBC owned studios or office space;~~
- c) ~~staff – for example, hiring out a BBC producer to an independent production company;~~  
~~and~~
- d) ~~business support – for example, provision of finance systems and information technology services for a BBC commercial subsidiary.~~

B.8 The primary function of the Public Service is as a broadcaster and it is organised and focused on fulfilling that role. The Public Service sells a range of goods and services to third parties and its Commercial Subsidiaries which may include any Joint Ventures they enter into. This includes licence fee funded content and intellectual property which could be sold to the Commercial Subsidiaries and/or other market participants as well as business support goods and/or services (such as human resources, IT, legal and finance) that are only shared with the Commercial Subsidiaries.

B.9 It is important to ensure that the prices the Commercial Subsidiaries, Joint Ventures and third parties are charged for these goods and services are set appropriately so that the Commercial Subsidiaries do not gain an unfair competitive advantage.

B.10 We consider that a “competition on the merits” approach is the relevant starting point for considering how a significant, publicly funded organisation, such as the BBC, should operate with respect to setting prices to both its Commercial Subsidiaries and third parties. This approach allows the Commercial Subsidiaries to benefit from certain legitimate advantages of scale and/or scope enjoyed by the Public Service provided that those advantages are replicable by comparable third parties.

B.11 Where the Public Service is supplying goods and/or services to its Commercial Subsidiaries or third parties, we consider that the relevant economic concept for the pricing of those goods and/or services is the “opportunity cost” to the Public Service.<sup>8</sup> Given the position of the Public Service in terms of providing inputs to downstream operations, the use of an opportunity cost approach best reflects the operation of an undistorted, competitive market in which firms are acting rationally and not strategically. In other words, we would not expect a rational firm to set prices (for intercompany transfers or otherwise) in such a way as to fulfil strategic aims such as improving the profitability of its commercial subsidiaries. A hypothetical rational commercial rival to the Public Service would not sell a product to its commercial subsidiary or a joint venture it has entered into unless it received a price at least as high as it could get from supplying a third party. Equally, for products that it would not supply to third parties, it would only supply them to its commercial subsidiaries if the price at least covered the incremental (or avoidable) costs it incurs from providing the product.

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<sup>8</sup> The opportunity cost reflects what the Public Service is giving up by choosing to supply a good or service to a particular party.

### Discrimination

- B.12 The BBC Public Service may supply goods and/or services solely to the BBC Commercial Subsidiaries only if there is a clear reason for exclusivity and/or where the goods and services are being shared for reasons of operational efficiency (such as business support goods and/or services). For instance, we do not expect the BBC to supply such 'business support' shared BBC group functions (e.g. finance, HR, IT, legal) to the wider market. goods and/or services to third parties given that the BBC is not "in the business" of supplying such goods and/or services. These goods and/or services are not unique to the Public Service, and can and are replicated by other providers.

In all cases where the BBC Public Service supplies goods and services to the commercial subsidiaries, it must ensure that arrangements are made on arm's length commercial terms<sup>9</sup> and comply with the transfer pricing requirements as set out below.

Where the BBC Public Service supplies goods and services to the wider market, they must be made available to third parties on equivalent terms and prices to commercial subsidiaries.

- B.13 To address the concerns, we have ~~around~~ about discriminatory access and pricing, where the BBC Public Service supplies goods and/or services to third parties the wider market, the BBC must not discriminate unduly against or between third parties. However, we recognise that in some cases there may be a fair and objective justification for offering different prices to different parties or refusing to supply goods and/or services to certain parties. For example, there may be cases where supplying to certain third parties could conflict with the BBC's Mission and Public Purposes.

## **Pricing requirements**

### Market-based pricing requirements

We set out at paragraph 3.5 that if BBC commercial subsidiaries were to pay less than the market price, and where similar terms or prices were not available to third parties, it would give the BBC's commercial subsidiary an unfair advantage (i.e. it would be able to operate at a lower cost than competitors).

It is therefore important that, where possible, the BBC's commercial subsidiaries should pay a market based transfer price for BBC Public Service goods and services. This will also help to ensure that the commercial activities carried out by the commercial subsidiaries operate in accordance with normal market principles.

It is also important that the BBC Public Service should not generally offer goods and services to the wider market at below market norms.

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<sup>9</sup> For the avoidance of doubt, the requirement that arrangements are made on arm's length commercial terms also applies to transactions whereby the Public Service is buying goods and services from the commercial subsidiaries (e.g. studio and production facilities from Studioworks).

- B.14 We consider that in most cases if the BBC did not supply the good or service to one of its Commercial Subsidiaries or Joint Ventures, it would be likely to supply it to a third party instead. In these instances, the appropriate basis for the transfer price should be the relevant market price or market benchmark. Where the Public Service is already supplying goods and/or services to third parties, we would expect that market prices and/or benchmarks are available and should continue to be used. Where the BBC is starting to supply a good and/or service for the first time, we would expect it to assess the most relevant approach, for example whether to make use of market benchmarks or an open market sale.
- B.15 We set out below a number of examples of different types of goods and services that we would expect to be priced using market prices or benchmarks:
- a) Supply of content / IP for secondary exploitation – the opportunity cost to the Public Service of supplying content / IP to its Commercial Subsidiaries would be the revenue the Public Service could have earned if the good or service had been sold to a third party.
  - b) Licensing of the BBC brand – the BBC brand is one of the most recognisable media brands in the world<sup>10</sup> and its development and maintenance have been funded by the licence fee. The Commercial Subsidiaries use the BBC brand in terms of their corporate names (e.g. BBC Studios) and the goods and services they offer (e.g. BBC Earth). The relevant opportunity cost for the BBC brand would be what a third party might be willing to pay to use it, taking into account any restrictions the Public Service might reasonably impose to protect the reputation and value of the BBC brand.
- B.16 One way of determining market prices is to put the good or service out to tender. If one of the Commercial Subsidiaries was successful at winning the tender, it would demonstrate that that Commercial Subsidiary placed the most value on the good or service in question. The Public Service would then earn the highest possible revenue and there would be no concern about discrimination or that the Commercial Subsidiary received an unfair competitive advantage.
- B.17 An open market process may also be an important input into establishing relevant market benchmarks for use in the transfer pricing of other goods and services as previous actual sales to third parties would be considered a legitimate source of benchmarking data.
- B.18 However, we also recognise that it is not always practicable to tender goods and/or services. Another way of determining market prices is for the BBC to establish what a market price would be through benchmarking of suitable comparators. When using benchmarks to set prices, the BBC should consider how representative the benchmark is in relation to the good or service in question and how recently that benchmarking analysis was undertaken. We would expect the BBC to be able to show that it had gathered relevant, verifiable and comparable evidence on prevailing market practices (including both prices and terms) for

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<sup>10</sup> It was valued as the 10<sup>th</sup> most valuable media brand in the world – Brand Finance 2018 [http://brandirectory.com/league\\_tables/table/global-500-2018](http://brandirectory.com/league_tables/table/global-500-2018).

the benchmarks it has used. This could include publicly available sources (e.g. published rate cards<sup>11</sup>), benchmarking studies or independent experts. We recognise that the relevant market rate for a given activity may vary depending on the nature of the arrangement in question. For example, prices for studio capacity booked at short notice may differ from prices for capacity booked well in advance.

B.19 The BBC should ensure that its benchmarks are reviewed regularly in line with market practice and be able to demonstrate the data is up to date and takes into account the nature and duration of the underlying contractual arrangements.

B.20 It may not be possible for the BBC to determine an absolute market benchmark for some of its goods and/or services – for example, if there was a range of benchmark products that were imperfect substitutes. In these circumstances, it is likely that there would be a range of prices within the benchmark and the relevant price should lie within this range.

B.21 With respect to the licensing of the BBC brand, we recognise that determining a price might be difficult. However, we note that the BBC currently charges its Commercial Subsidiaries for the use of its brand as a proportion of the revenues that are directly linked to its use. We consider this may be a reasonable proxy for the value of the BBC brand.

B.22 The Requirements also allow for prices to be set based on costs in some rare cases where the Public Service is unable to identify appropriate, reliable benchmarking data or where it may not be proportionate to undertake benchmarking, for example for immaterial, one off transactions. In these instances, we would expect that the long-run cost is a proxy for the market price and, as such, includes a mark-up on costs.

B.23 Finally in some limited circumstances it may be acceptable that prices are set with reference to incremental costs as long as the BBC can demonstrate that this is the market benchmark or conforms to prevailing market practice prices, and they at least cover the BBC's short-run incremental costs. For example, for occasional ad hoc sales of unused office space that would otherwise have been left vacant, prices that cover short-run incremental costs may be appropriate even if the contribution to fixed costs is small (so long as there is no repeated pattern of such sales).

#### Shared business support services pricing requirements

B.24 Where the Public Service is only sharing, and is only ever likely to share, goods and/or services with its Commercial Subsidiaries, then the opportunity cost is the long-run costs of provision to the Public Service. That is, the alternative would be for the Public Service to scale back or discontinue provision (rather than offer the good or service to third parties). This should be the case in the specific situations where the Public Service is sharing business support goods and/or services with the Commercial Subsidiaries.

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<sup>11</sup> An example of where a rate-card may be used is for hiring a studio. We recognise that published rate-cards may not always be an accurate representation of actual prices paid for goods and/or services. That is, the rate-card may only serve as a starting point for commercial negotiations over price.

- B.25 The opportunity cost to the Public Service of these business support functions would be based on the long-run incremental costs of provision of these goods and/or services to its Commercial Subsidiaries. In this situation, cost-based prices could be derived from either:
- a) the long-run incremental costs incurred by the Public Service in providing these goods and/or services; or
  - b) the long-run costs avoided if the Public Service no longer provided the goods and/or services to the Commercial Subsidiaries.
- B.26 We expect that these two approaches would have equivalent outcomes. However, we recognise that in practice it may not be possible to set transfer prices on a pure, long-run incremental cost basis or that it may not be proportionate to do so. For example, reliable data may not be available on the level of the long-run incremental costs. In these cases, fully allocated costs may be a reasonable proxy for long-run incremental costs.
- B.27 Where the BBC has procured a contract on behalf of the entire BBC Group, it is important to ensure that at a minimum an appropriate increment of the contract cost is charged to the Commercial Subsidiaries.
- B.28 Given our competition concerns are in relation to the Commercial Subsidiaries gaining an unfair competitive advantage, the BBC can set transfer prices for goods and services supplied to the Commercial Subsidiaries that are higher than the market price or cost (depending on the methodology used), if it wishes to do so.

Accordingly, pricing for goods and services supplied by the BBC Public Service, whether sold to the BBC's commercial subsidiaries or to third parties, must be set on the basis of the following principles. The BBC should consider whether it would be appropriate to sell goods and services through an open market process. For example, where feasible, a competitive tendering/bidding process would be the best way to identify the market price for the good or service in question.

Absent an open market process, in pricing the goods and services of the BBC Public Service, the BBC must use any verifiable, comparable information on prevailing market practices (including both prices and terms and conditions). In particular, we expect the BBC Public Service to use market benchmarking to value the secondary and ancillary rights of its originated content in most cases.

Where possible, evidence should be gathered from publicly available sources (e.g. published rate cards). It may also be appropriate to use benchmarking studies or independent experts. Where it is not possible to price goods and services by reference to market benchmarks (for example because the asset is unique and has no close comparators) then it would be appropriate for the BBC to adopt a cost-based approach to derive a transfer price. The BBC must be able to justify using this approach, for example with reference to the work done to assess the availability of any relevant market benchmarks. As set out in our requirements, the price must cover:

- All relevant direct costs involved in providing the good(s) or services; and

- An appropriate contribution to the relevant overheads and capital costs incurred by the business areas together with an appropriate contribution for reinvestment in the BBC Public Service activities.<sup>12</sup>

In some circumstances it may be acceptable to set prices with reference to incremental costs. The BBC must be able to demonstrate that such an approach conforms to prevailing market practice. For example, for occasional ad hoc sales of studio capacity that would otherwise have been left vacant, prices that cover short run incremental costs may be appropriate even if the contribution to fixed costs is small (so long as there is no repeated pattern of such sales). However, for longer term contracts, or where ad hoc contracts together amount to a significant stream of ongoing business, we would expect prices to include some contribution to the fixed costs of maintaining studio space.

The BBC must not set prices below the incremental costs of providing a good or service.

The BBC must ensure that any pricing methodologies and terms and conditions are reviewed regularly, and consistent approaches are applied to any similar goods and services. This would also apply to agreements for use of the BBC brand.

### Supply by Commercial Subsidiaries to the Public Service

B.29 There are a number of instances where the Commercial Subsidiaries supply goods and services to the Public Service. This includes studio capacity, post production facilities and new content. Where this is the case our main competition concern is that the Public Service could use its special funding position to pay inflated prices for goods and/or services supplied by its Commercial Subsidiaries and so confer an unfair advantage on them by boosting their revenues and overall rates of return.

B.30 The guidance set out above in relation to market prices and benchmarks also applies when determining how much the Public Service should pay for goods and/or services supplied by the Commercial Subsidiaries. In particular, if market benchmarks are used, they should be relevant, verifiable and regularly reviewed.

B.31 Requirement B.5 does not apply to the supply of original programming and content by BBC Studios to the Public Service through the commissioning process, which is subject to the Commissioning Requirements.

### Exception for ticket sales

B.32 We note that clause 49(4)(h) of the Agreement envisages the BBC recovering a contribution to the costs of staging certain events from the proceeds of ticket sales in accordance with a statement of policy that is agreed with the Secretary of State. The events are "The Proms, Proms in the Park, Cardiff Singer of the Year, Young Musician of the Year; and any other similar events which contribute to the BBC's Mission and Public Purposes". In recognition of this, our pricing requirements do not apply to the pricing of

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<sup>12</sup> These requirements are informed by the BBC's current Fair Trading Guidelines as of 2016, but are subject to further review by Ofcom.

tickets for these events. Therefore, the BBC may continue to price tickets for these events in line with a statement of policy that is agreed with the Secretary of State pursuant to clause 49(4)(h). We recognise that the BBC can seek to recover a contribution to the costs of staging these events from the proceeds of ticket sales but that this cost recovery might not extend to covering the costs of broadcasting these public service events.

### Reporting requirements for Section B

#### **~~Transparency for transfer pricing methodologies~~**

- B.33 ~~Transparency around the relationship between the BBC Public Service and commercial subsidiaries with regards to transfer pricing has a number of advantages. It provides stakeholders with information to assess if the BBC is complying with its obligations and can, if necessary, support the complaint handling and enforcement process to determine whether the BBC is complying with its obligations. It should also improve confidence in the regulatory framework around the BBC's commercial activities. We have set out requirements for the BBC around transparency of transfer pricing methodologies at paragraphs 4.31 onwards. We also gather information on how the BBC is complying with Requirements B.1 to B.7 inclusive through separate monitoring, reporting and transparency requirements. These are set out in Section D of the Requirements, Requirements D.5 to D.8.~~

## C. Commercial rate of return

### Requirements

- C.1 The BBC must over an appropriate period of time, e Earn a commercial rate of return on its Commercial Activities:-
- a) at the Commercial Subsidiary level; and
  - b) at the line of business level.
- C.2 The BBC must assess and set what an appropriate commercial rate of return is for each of the activities referred to in Requirements C.1(a) and C.1(b). ~~line of business, including monitoring and researching the markets in which it operates to ensure that the returns generated by its commercial activities are in line with market norms.~~
- C.3 ~~Inform Ofcom where a line of business is not making a commercial rate of return.~~ Where the BBC considers that one or more of the activities referred to in Requirements C.1(a) and C.1(b) are not likely to earn a commercial rate of return over an appropriate period of time, the BBC must, as soon as practicable, conduct a performance review. Following that review the BBC must implement any necessary steps, including a revised business plan, to enable the activities in question to earn a commercial rate of return over that period of time.
- C.4 ~~Where a line of business is not earning a commercial rate of return, review performance and consider any necessary steps to move to earning a commercial rate of return. In the first instance, the BBC should decide whether the activity should be modified, scaled back, stopped or divested.~~ For the purposes of Requirements C.1 to C.3, the BBC must:
- a) set appropriate lines of business; and
  - b) inform Ofcom as soon as practicable where it proposes to make any changes to any of its lines of business.

~~Where the BBC decides to continue a line of business which is not making a commercial rate of return the business plan must show the line of business reaching a commercial rate of return within an appropriate period of time.~~

~~If Ofcom requests access to the business plan for a line of business, provide Ofcom with supporting information as necessary so as to satisfy Ofcom that the business plan is realistic.~~

### Guidance

#### Appropriate commercial rate of return

- C.5 The Agreement states that Ofcom may set requirements to ensure that the commercial activities are carried out in accordance with normal market principles, including making a commercial rate of return.<sup>13</sup> ~~We are imposing a requirement that the BBC commercial~~

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<sup>13</sup> Agreement, Clause 28 (1) (a).

activities earn a commercial rate of return. We consider that this helps to: [Requirements C.1 to C.4 inclusive help to:](#)

- a) ensure that BBC public funding is not used to finance loss making [Commercial Activities](#); and
  - b) reinforce the principle that [Commercial Activities](#) are undertaken on an arm's length basis and in accordance with normal market principles.
- C.6 At the same time, a [key aspect](#) of the return earned by a [Commercial Activity](#) will be the price it [the Commercial Subsidiary or the line of business in question](#) has paid for its inputs. We do not ~~propose to~~ focus on the rate of return in isolation and [in each case](#), it ~~will be necessary to~~ [we will usually](#) consider a [Commercial Activity](#)'s rate of return in combination with transfer pricing to assess whether the relationship between the BBC Public Service and a [Commercial Activity](#) has had [an unfair competitive advantage or](#) a market distorting effect. We also consider that it would not be appropriate to focus on a specific measure of rate of return but rather to use the rate of return metric that is most relevant to the market [or](#) line of business in question.<sup>14</sup>
- C.7 ~~Ofcom is requiring the BBC to assess what an appropriate commercial rate of return is for each line of business. That is, it would not be sufficient for the BBC just to demonstrate that overall a commercial subsidiary was earning a commercial rate of return. The BBC is required to assess what an appropriate commercial rate of return is for Commercial Activities at the Commercial Subsidiary level and the line of business level. However, Ofcom would not necessarily expect the BBC the BBC is not required to carry out such an analysis at the level of individual goods and/or services or specific activities (e.g. individual book titles). The BBC must propose to Ofcom how it will define specific lines of business within the commercial subsidiaries.~~
- C.8 In assessing whether the [commercial](#) rate of return of a [Commercial Subsidiary and each line of business within that Commercial Subsidiary](#) is appropriate, we would consider, amongst other things, whether a rational private investor would invest in ~~that~~ [the activity Commercial Subsidiary and/or that line of business](#). We would expect a private investor to carry out an investment project if the expected return on the investment is higher than the opportunity cost of capital. By the opportunity cost of capital we mean the return that a private investor could expect to make on other investments of similar risk in the capital markets.
- C.9 In using this approach, it is important to recognise:
- a) A [Commercial Subsidiary and/or](#) line of business need not generate a profit every year, particularly if it is a new activity. For example, a business plan may project a loss in the early years of a new activity, ~~for example,~~ as the business grows. However, the plan must forecast a profit [that it will achieve a commercial rate or return](#) ~~(by which we~~

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<sup>14</sup> For example, rates of return can be measured in terms of: return on capital employed; return on sales; return on investment etc.

mean the expected return is higher than the opportunity cost of capital) over an appropriate period of time;

- b) ~~In principle, we would expect every line of business to be profitable~~ [Requirement C.1 provides that Commercial Activities at the Commercial Subsidiary level and at the line of business level must earn a commercial rate of return](#) over an appropriate time period. However, in some circumstances an investment in one line of business could generate indirect returns elsewhere, and a rational investor may accept low returns on a specific investment if this investment produces high returns for the same investor from other assets. Where this is the case we would expect the BBC to be able to demonstrate ~~the business plan for~~ how low returns on one line of business supported higher returns elsewhere [in order to show that the low returns nevertheless represent appropriate commercial rates of return; and](#)
- c) The actual (ex-post) return could be very different (higher or lower) than the estimated return at the time the investment is made.; and
- d) ~~The focus is on the return arising due to the specific investment project or line of business, not the return for the overall subsidiary or accounting profitability.~~

## **Commercial rate of return requirements**

~~The BBC must establish the appropriate rate of return for each of the lines of business and ensure that the activity is undertaken in such a way that it delivers this rate of return.~~

- C.10 What constitutes a commercial rate of return will depend on the specific market circumstances and ~~Ofcom does~~ [the Requirements do](#) not propose to specify rates of return. Instead, the BBC must monitor and research the markets in which [Commercial Subsidiaries and](#) the lines of business operate [\(including using benchmark rates of return\)](#) to ensure that the returns generated by [their](#) ~~its~~ [Commercial Activities](#) are in line with [commercial rates of return](#) market norms.
- C.11 ~~In situations where indirect returns could be a relevant consideration, our starting point would still be that we expect a commercial activity to earn a commercial rate of return and that it would be up to the BBC to make the case why a lower rate of return was appropriate, and to quantify it. To the extent that the BBC argued that a lower rate of return was required to assist in the delivery of its Public Purposes, we would want to understand why the BBC had chosen to deliver against the Public Purposes in that way,~~ [Given that Commercial services Activities must be separate from the delivery of the Public Purposes and](#) are only required to fit with the [BBC's Mission and Public Purposes](#), [a non-commercial rate of return cannot be justified on the grounds of assisting the delivery of the BBC's Mission and Public Purposes. However, in considering whether to \(i\) investigate a potential breach of Requirements C.1 to C.4, and \(ii\) impose a penalty in the event that a breach is found, we will take into consideration, among other factors set out](#)

in our Enforcement Procedures,<sup>15</sup> any link between the Commercial Activity in question and the other activities carried out by the BBC which are subject to the regulatory regimes established by the Operating Framework.

If there are concerns that the BBC has not established an appropriate rate, or has not established it at a sufficiently granular level, Ofcom may review the BBC's work in establishing the rate of return and make directions to the BBC to develop an appropriate rate of return.

- C.12 The BBC may of course set additional rate of return benchmarks either for its own internal investment appraisal purposes or in terms of setting performance targets for existing Commercial Aactivities. For instance, the BBC may set specific targets for its Ccommercial Aactivities which are intended to be more challenging than simply earning a commercial rate of return.

### Suspected f~~ailure~~ to meet an appropriate commercial rate of return

- C.13 We recognise that there may be situations where returns ~~fall below the commercial rate~~ are low, particularly in the short term. For example, unexpected changes to market or economic conditions may cause performance to deviate from expectations.
- C.14 ~~Where a line of business is not making a commercial rate of return, then Ofcom must be informed. In this situation, in the first instance, Ofcom requires the BBC to~~ However, if the BBC considers that an activity is not likely to earn a commercial rate of return over an appropriate period of time, under Requirement C.3 the BBC is obliged to follow the specified process and take remedial steps. In reviewing performance and ~~consider~~ implementing any necessary steps to move to earning a commercial rate of return. ~~In~~ particular, the BBC must decide whether the line of business should be modified, scaled back, stopped, or divested.

~~Where the BBC decides that a line of business is continued, a specific and credible business plan must show it reaching a commercial rate of return within an appropriate period.~~

~~Ofcom may request the business plan and further information as necessary to provide reassurance that any loss making line of business is not being financed from the BBC's public funding. The BBC is responsible for providing Ofcom with sufficient supporting information to enable Ofcom to satisfy itself that the business plan is realistic.~~

- C.15 ~~Where Ofcom is~~ we are concerned that a line of business is not earning a commercial rate of return ~~the BBC has not complied with one or more of Requirements C.1 to C.4, or~~ considers that remedial steps decided on by the BBC are insufficient to rectify performance, ~~Ofcom~~ we will consider whether to may launch an investigation. If, in those circumstances following such an investigation, ~~Ofcom~~ we finds that the BBC has failed to comply with the ~~R~~Requirements, in this document and there is a risk of market distortion or one of the BBC's commercial activities gaining an unfair competitive advantage due to its relationship with

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<sup>15</sup> Statement on Procedures for enforcement of BBC competition requirements which is available at: [https://www.ofcom.org.uk/data/assets/pdf\\_file/0011/102521/Statement-on-Procedures-for-enforcement-of-BBC-competition-requirements.pdf](https://www.ofcom.org.uk/data/assets/pdf_file/0011/102521/Statement-on-Procedures-for-enforcement-of-BBC-competition-requirements.pdf)

the BBC Public Service, Ofcom we may direct the BBC to take action to ~~make~~ ensure that the Commercial Subsidiary and/or line of business ~~profitable~~ earn an appropriate commercial rate of return within an appropriate time period or do anything else ~~Ofcom~~ we considers appropriate to remedy the ~~situation~~ breach. In considering whether to open an investigation and whether to impose a penalty in the event that a breach is found, we will take into account, among other factors set out in the Enforcement Procedures, the extent of any risk of market distortion, or the Commercial Activity in question gaining an unfair competitive advantage, as a result of its relationship with the Public Service.

C.16 For the avoidance of doubt, where a Commercial Subsidiary has entered into a Joint Venture, the revenues and costs associated with this Joint Venture should be included in the relevant lines of business.

#### **Reporting requirements for Section C**

C.17 We also gather information on how the BBC is complying with Requirements C.1 to C.4 inclusive through separate monitoring, reporting and transparency requirements. These are set out in Section D of the Requirements, Requirements D.9 to D.16.

## **D. Monitoring, reporting and transparency**

### **Requirements**

~~Publish the methodologies it uses to establish transfer prices for each type of good or service that the BBC Public Service supplies to commercial activities.~~

~~Publish the methodologies it uses for valuing the BBC brands.~~

~~Notify Ofcom and publish any material changes to any of its methodologies for calculating an appropriate transfer price, including a statement of the impact of the relevant methodological changes.~~

~~Ensure that reports and accounts covering each of the commercial subsidiaries are published each year (including on their websites) and that these:~~

- ~~a) contain a clear description of the lines of business comprised within the BBC's commercial subsidiaries;~~
- ~~b) provide financial and performance information; and~~
- ~~c) include information broken down for different types of business.~~

~~Inform Ofcom annually of the forward looking commercial rate of return it considers appropriate for each line of business.~~

~~Keep the performance of its commercial activities under review to ensure that they generate an appropriate commercial rate of return and, on a quarterly basis, provide a report on the financial performance of each line of business to Ofcom, including relevant revenues, costs and profits, and the performance against the target commercial rate of return.~~

~~Maintain records of its trading activities with third parties.~~

### **Separate subsidiary and operational separation**

D.1 The BBC must publish, each Financial Year at the same time as the BBC Annual Report is published for that Financial Year, total revenues of the Trading Activities with third parties which have been carried out by the Public Service. The total revenues of the Trading Activities must be split by key categories including, as a minimum, rental income and royalties income.

D.2 The BBC must publish, each Financial Year at the same time as the BBC Annual Report is published for that Financial Year, an Operational Separation Statement setting out how the BBC has complied with Requirements A.1 to A.5 inclusive during that Financial Year. Each Operational Separation Statement must include as a minimum the following:

- a) an overview of the processes the BBC has adopted in identifying areas of risk for information sharing;
- b) a description of all measures, controls and processes implemented to ensure compliance with Requirements A.1 to A.5 inclusive, including any relevant internal codes or policies;

- c) an account of how the governance of the Commercial Subsidiaries reflects Requirements A.1 to A.5 inclusive;
- d) an explanation of any issues with the effectiveness of the BBC's controls during the previous Financial Year and what steps the BBC has taken to improve their effectiveness;
- e) a description of the relevant measures, controls and processes in the following areas:
  - i) information sharing;
  - ii) governance arrangements;
  - iii) conflicts of interest;
  - iv) IT systems;
  - v) appropriate arrangements for co-located employees, including controls applicable if employees of the Public Service and one or more of the Commercial Subsidiaries or Joint Ventures share the same building(s); and
  - vi) training of the employees of the BBC and internal guidance on ensuring the BBC's compliance with Requirements A.1 to A.5 inclusive.

D.3 The BBC must inform Ofcom, each Financial Year at the same time as the BBC Annual Report is published for that Financial Year, of all conflicts of interest identified pursuant to Requirement A.5 during that Financial Year, including the details of each conflict and the action the BBC has taken to address each conflict.

D.4 For each board and executive committee governing Commercial Subsidiaries, the BBC must publish each Financial Year at the same time as the BBC Annual Report is published for that Financial Year, and keep updated on an on-going basis in a prominent place on the relevant publicly available website operated or controlled by the BBC, the following:

- a) terms of reference;
- b) a list of all members sitting on each board and executive committee;
- c) identification of those members who are Public Service employees; and
- d) the reporting arrangements between each board and executive committee.

### **Supply and pricing of goods and services**

D.5 The BBC must publish each Financial Year at the same time as the BBC Annual Report is published for that Financial Year:

- a) Pricing Methodology Manuals, which must set out the methodologies the BBC has used in that Financial Year to establish:
  - i) Transfer Prices for each category of goods and/or services that the Public Service supplies to the Commercial Subsidiaries;
  - ii) Transfer Prices for each category of goods and/or services that each Commercial Subsidiary supplies to the Public Service, except those categories of good and/or service which are subject to the Commissioning Requirements; and

- iii) prices for each category of goods and/or services that the Public Service supplies to third parties;
- b) a list of all changes that the BBC has made during that Financial Year to any of its methodologies for calculating Transfer Prices and prices referred to in Requirements D.5(a)(i) to D.5(a)(iii) inclusive, including:
  - i) an explanation of the reasons for those changes; and
  - ii) a statement of the impact of those changes;
- c) a breakdown of total Transfer Charges for that Financial Year charged by the Public Service to each Commercial Subsidiary, and each Commercial Subsidiary to the Public Service, each breakdown split by:
  - i) the key categories used in the Pricing Methodology Manuals, which as a minimum must include property, human resources, business affairs, finance, legal and procurement; and
  - ii) the total amounts that were paid or written off during the Financial Year, or remained unpaid as at the end of the Financial Year; and
- d) the methodologies the BBC has used in that Financial Year for valuing the BBC brands.

D.6 The BBC must provide to Ofcom at the same time as the BBC Annual Report is published for that Financial Year:

- a) totals of all the transactions conducted in that Financial Year between the Public Service and each Commercial Subsidiary split by key categories showing how the balances at the end of the Financial Year have been derived from the balances which were in place at the start of the Financial Year; the key categories of transactions conducted between the Public Service and each Commercial Subsidiary must include, as a minimum, total Transfer Charges, dividends and loans; and
- b) explanations and calculations showing how the transactions referred to in Requirement D.6(a) are treated in preparing the consolidated balance sheet and income statement of the BBC Group for the Financial Year.

D.7 The BBC must provide to Ofcom:

- a) any changes that the BBC has made since the most recent publication pursuant to Requirement D.5(b) to any of its methodologies for calculating Transfer Prices and prices referred to in Requirements D.5(a)(i) to D.5(a)(iii) inclusive, including:
  - i) an explanation of the reasons for those changes; and
  - ii) a statement of the impact of those changes; and
- b) a breakdown of total Transfer Charges charged by the Public Service to each Commercial Subsidiary; and each Commercial Subsidiary to the Public Service, each breakdown split by:

- i) the key categories used in the Pricing Methodology Manuals, which as a minimum must include property, human resources, business affairs, finance, legal and procurement;
- ii) for each key category, the amounts charged in the first half of the Financial Year and the whole of that Financial Year compared with the Contracted Amounts for the first half of the Financial Year and the whole of that Financial Year respectively (as applicable);
- iii) the total amounts that were paid or written off during the first half of the Financial Year and the whole of that Financial Year (as applicable), or remained unpaid as at the end of the first half of the Financial Year and at the end of that Financial Year (as applicable); and
- iv) the total amounts that were paid or written off in that Financial Year in relation to previous Financial Years' Transfer Charges, and the amounts that remained unpaid as at the end of the Financial Year from previous Financial Years' charges.

D.8 The information pursuant to Requirement D.7 must be provided:

- a) for the first half of the Financial Year, no later than three months after the end of the first half of the Financial Year as applicable; and
- b) for the whole of the Financial Year, at the same time as the BBC Annual Report for that Financial Year is published as applicable.

### **Commercial rate of return**

#### *Publication of reports on financial performance*

D.9 The BBC must publish, each Financial Year at the same time as the BBC Annual Report is published for that Financial Year, reports on the financial performance of each Commercial Subsidiary in that Financial Year which must:

- a) contain a clear description of the activities carried out by each Commercial Subsidiary and each line of business within that Commercial Subsidiary; and
- b) set out the financial performance of that Commercial Subsidiary and each line of business within that Commercial Subsidiary, including in each case:
  - i) the rates of return;
  - ii) a definition of the metrics used for those rates of return;
  - iii) the revenues, costs, assets, liabilities, capital employed and cash flows used in the calculation of those rates of return split into key categories together with a description of those key categories;
  - iv) a demonstration of how the figures required in D.9(b)(iii) reconcile to the statutory accounts of the relevant Commercial Subsidiary; and
  - v) explanations of the financial performance as required by D.9(b)(i) and D.9(b)(iii).

Provision of Target Rates of Return information to Ofcom

D.10 The BBC must provide to Ofcom no later than the first day of each Financial Year the Target Rates of Return the BBC considers appropriate for each Commercial Subsidiary and each line of business within that Commercial Subsidiary, setting out in each case:

- a) a clear description of the activities carried out by each Commercial Subsidiary and each line of business within that Commercial Subsidiary;
- b) a definition of the metrics used for assessing those Target Rates of Return and reasons for selecting those metrics;
- c) the revenues, costs, assets, liabilities, capital employed and cash flows used in the calculation of those rates of return, split into key categories together with a description of those key categories;
- d) explanations of cost attribution methods applied to common costs in the calculation of those Target Rates of Return; and
- e) reasons and evidence that the BBC has used in forming its view on whether each of those Target Rates of Return is appropriate, including all information concerning market benchmarks and/or reports prepared by the BBC and/or third parties for the BBC.

D.11 The information required under Requirement D.10 must be provided for all the future Financial Years included in the period for which the BBC has prepared its budgets and/or business plans.

D.12 In the event that the Target Rates of Return for any Commercial Subsidiary or any line of business within a Commercial Subsidiary fall below the BBC's assessment of the commercial rate of return, the BBC must provide to Ofcom as soon as practicable the following information:

- a) explanation of the steps the BBC is planning to take for the Commercial Subsidiary or the line of business in question to reach a commercial rate of return;
- b) the period of time after which the BBC expects that that commercial rate of return will be reached and the reasons why the BBC considers that period of time to be appropriate; and
- c) any business planning and budgeting information necessary to support the information provided under D.14(a) and (b).

Provision of achieved rates of return information to Ofcom

D.13 The BBC must provide to Ofcom the following information for each Commercial Subsidiary and each line of business within each Commercial Subsidiary:

- a) the achieved rate of return, setting out the revenues, costs, assets, liabilities, capital employed and cash flows used in the calculation of those rates of return, each split into key categories together with a description of those key categories;

- b) Budgeted Figures for the key categories of the revenues, costs, assets, liabilities, capital employed and cash flows, and an explanation of any differences between the actual figures and the Budgeted Figures;
- c) explanations of cost attribution methods applied to common costs in the calculation of the rates of return;
- d) a separate split of total revenues and costs used in the calculation of the rates of return as per D.13(a) into the following:
  - i) those which relate to the Public Service;
  - ii) those which relate to other Commercial Subsidiaries;
  - iii) those which relate to other lines of business within the same Commercial Subsidiary;  
and
  - iv) those which relate to third parties.

D.14 The information must be provided pursuant to Requirement D.13:

- a) for the first half of the Financial Year, no later than three months after the end of the first half of the Financial Year; and
- b) for the whole of the Financial Year, at the same time as the BBC Annual Report for that Financial Year is published.

D.15 In the event that a rate of return achieved by a Commercial Subsidiary and/or a line of business within that Commercial Subsidiary is lower than the target rate of return for the relevant period, the BBC must inform Ofcom as soon as practicable of the following:

- a) the reasons for the difference between the target rate of return and the achieved rate of return; and
- b) explanation of the steps that the BBC has already taken, and/or is intending to take, in order to achieve the target rate of return.

#### Other requirements

D.16 In addition to Requirements D.12 and D.15, if at any other point in time the BBC identifies that a Commercial Subsidiary and/or a line of business within a Commercial Subsidiary is not expected to earn a commercial rate of return over an appropriate period of time, the BBC must provide to Ofcom as soon as practicable the following information:

- a) explanation of the steps the BBC is planning to take in relation to the Commercial Subsidiary and/or the line or business in question;
- b) if the BBC decides to take steps to ensure the Commercial Subsidiary and/or the line of business in question reaches a commercial rate of return, the period of time after which the BBC expects that that commercial rate of return will be reached and the reasons why the BBC considers that period of time to be appropriate; and
- c) any business planning and budgeting information necessary to support the information provided under D.16(a) and (b).

### General

- D.17 The information published or provided pursuant to Requirements D.1 to D.16 must include information in relation to any subsidiaries of the Commercial Subsidiaries and any joint ventures in which the Commercial Subsidiaries may participate.
- D.18 The BBC must include and/or take account of all material items of information in complying with Requirements D.1 to D.16. A material item of information is one which is reasonably expected to affect the views of a competent user of the publications and submissions which BBC is required to make under Requirements D.1 to D.16.
- D.19 Requirements D.5(a) and (b) do not apply to any transactions between the Public Service and the Commercial Subsidiaries which are subject to the Commissioning Requirements.
- D.20 Requirement D.5(c) applies to all transactions between the Public Service and the Commercial Subsidiaries, including transactions which are subject to the Commissioning Requirements.
- D.21 The information provided or published (as applicable) pursuant to Requirements D.5(b), D.5(c), D.6, D.7(a), D.7(b), D.10, D.11 and D.13 must be prepared, as a minimum, as to form and content in the manner set out in Part 3 of this Schedule.
- D.22 Any information published under Requirements D.1 to D.16 must be effected by the BBC by placing a copy of the information in a prominent place on the relevant publicly available website operated or controlled by the BBC.
- D.23 The BBC must maintain accounting records, including but not limited to relevant correspondence, contracts and invoices, for a period of six years from the date on which each record was created and ensure that those records are sufficient to provide an adequate explanation of how the BBC has complied with each of the Requirements, including an adequate explanation of the information published and provided to Ofcom (as applicable) pursuant to Requirements D.1 to D.16.

### Guidance

Reporting and publication of information are important for transparency. This in turn allows Ofcom to monitor trading and separation, and gives confidence to the wider market that the BBC is complying with its regulatory obligations and its own policies.

The Agreement sets out that Ofcom may set requirements to ensure that the relationship between the BBC Public Service and the commercial subsidiaries is appropriately transparent, including both the provision of financial reports to Ofcom and the publication of information about the relationship between the BBC Public Service and the commercial subsidiaries.

This section sets out the requirements we are placing on the BBC around reporting to Ofcom and the publication of information by the BBC related to the relationship between the BBC Public Service and the commercial subsidiaries.

### Reporting of transfer pricing methodologies

As noted at paragraph 4.11 above, we consider that greater transparency in relation to transfer prices could improve confidence in the regulatory framework around the BBC's commercial activities. We have considered whether it would be appropriate to require the BBC to publish the actual prices the BBC Public Service charges the commercial subsidiaries. We recognise that this could raise issues around commercial confidentiality and, at this point in time, have decided against this approach.

However, we do not see those same issues of commercial confidentiality arising in respect of the underlying methods used by the BBC to determine transfer prices in practice and see merit in there being greater transparency in this area. As a result, we require the BBC to publish the methodologies it uses to establish transfer prices for each type of good or service that the BBC Public Service supplies to its commercial activities. This includes providing details on whether the price is based on a market rate, market benchmarking or a cost-based approach together with an indication of how different factors have been taken into account in determining prices. In the case of a cost-based price, the BBC should include how that price is derived.

The BBC must also publish an explanation of the methodologies it uses for valuing the BBC brands.

The BBC must notify Ofcom and publish any material changes to any of its methodologies for calculating an appropriate transfer price, and provide a statement of the impact of the relevant material changes.

### Reporting of accounts and performance information

The BBC Board must ensure that reports and accounts covering each of the commercial subsidiaries are published each financial year (including on their websites) and that these:

- a) contain a clear description of the services and activities comprised within the BBC's commercial subsidiaries;
- b) provide financial and performance information; and
- c) include information broken down for different types of business.

The BBC must inform Ofcom each financial year of the forward-looking commercial rate of return it considers appropriate for each line of business. This will enable Ofcom to compare the BBC's expected returns with those achieved where appropriate.

The BBC must keep the performance of its commercial activities under review to ensure that they generate an appropriate commercial rate of return. On a quarterly basis, the BBC must provide a report on the financial performance of each line of business to Ofcom, including relevant revenues, costs and profits, and the performance against the target commercial rate of return.

This Guidance sets out the principles that Ofcom will follow on reporting and monitoring. The detail of the reporting framework will evolve over time.

### **Requirement to maintain records of trading activities**

~~The BBC must maintain records of its trading activities with third parties and the general public.~~

~~The BBC maintaining records of its trading activities will allow Ofcom to investigate complaints or carry out own-initiative investigations as required.~~

~~We expect to engage with the BBC periodically to ensure that its records are sufficient for our purposes.~~

### **Other information**

~~Ofcom may require the BBC to provide, and if necessary publish, additional information to fulfil its regulatory responsibilities.~~

### **Purpose of publication and provision of information to us**

- D.24 We consider that publication and provision of information to us are important to ensure transparency. This in turn allows us to monitor Commercial and Trading Activities carried out by the BBC and gives confidence to third parties that the BBC is complying with its regulatory requirements and its own policies.

### **Reporting of information concerning supply of goods and/or services**

- D.25 In order to comply with Requirement D.6(b), the explanations and calculations provided by the BBC must demonstrate how the transactions and the balances due between the Public Service and each Commercial Subsidiary are adjusted or eliminated in aggregating the income statements and balance sheets of those entities into the consolidated income statement and balance sheet of the BBC Group.

### **Reporting of commercial rate of return information**

- D.26 We expect the BBC to determine the appropriate “key categories” of the revenues, costs, assets, liabilities, capital employed and cash flows referred to in the Requirements D.9, D.10 and D.13.