

The BBC's commercial activities: a consultation on Ofcom's proposed requirements and guidance

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I Executive summary

- I.1 The BBC welcomes the chance to comment on the draft requirements Ofcom proposes to place on the BBC to avoid the relationship between the BBC's commercial and public service activities distorting the market or creating an unfair advantage. This response is divided into three main sections. The first explains the market context in which the BBC's commercial subsidiaries operate; the second sets out the existing, well-established practices regarding separation and trading which will be the basis for the BBC Board's approach to overseeing the commercial activities; and the third sets out the BBC's view on how Ofcom could revise some of its proposed requirements to make them more effective, targeted and proportionate.

Market context

- I.2 It is widely recognised that the UK's media sector is increasingly operating in a global context. Media markets have seen a strong tendency towards vertical integration of production, distribution and broadcast assets. Looking at the BBC's subsidiaries within their relevant market contexts, it is clear that they do not occupy positions that would normally raise competition concerns.

BBC's established practices

- I.3 Ofcom's proposals should be viewed in light of the fact that the BBC already operates a well-established separation and trading framework which is rooted in state aid principles and EU/UK competition law. The framework is designed to ensure that the BBC's public funds do not confer an unfair advantage on the BBC's commercial activities resulting in market distortion, while allowing the BBC to stay in line with relevant market norms and to maintain strategic alignment between its publicly-funded and commercial activities. The BBC will continue to have mechanisms in place to ensure compliance with these principles. The main elements of the framework are:
- I.4 **Operational Separation** - There is financial and organisational separation between the BBC's public service and commercial activities – its subsidiaries operate at arm's length with no public service subsidy or underwriting of their activities. Market norm levels of strategic alignment between the BBC

Public Service and its wholly-owned subsidiaries are vital in order to generate returns for licence fee payers.

- 1.5 **Supply of Goods and Services** - The BBC avoids exclusive access for commercial subsidiaries to goods and services where it would provide an unfair advantage, even if the good or service in question is fairly priced. However, absent such a risk of unfair advantage, the BBC would not generally provide its goods and services more widely unless it is explicitly permitted to within the parameters of the Framework Agreement.
- 1.6 **Transfer Pricing** – The BBC’s framework is designed to ensure that the BBC’s commercial subsidiaries operate in line with market norms and provides for a fair allocation of costs. This applies both where the BBC is acquiring products or services from its own subsidiaries - which will be subject to market testing and/or benchmarking where market testing is not feasible - and where the BBC has transactional relationships with its subsidiaries to provide access to goods and services - which will be recharged at cost.
- 1.7 **Commercial Rate of Return** - All the BBC’s commercial subsidiaries must be commercially efficient on an ongoing basis. Commercial efficiency is judged by reference to the market in which the subsidiary in question operates and takes into account relevant strategic benefits that comparable market operators would recognise.
- 1.8 **Transparency, Monitoring & Reporting** - The BBC aims to strike a balance between transparency and the need for its subsidiaries to operate efficiently and in a way that does not put them at a competitive disadvantage in competitive markets. The BBC meets higher transparency standards than are required of its commercial peers.

Response to Ofcom’s proposed requirements and guidance

- 1.9 It is important that Ofcom’s regulatory requirements are principle-based, non-intrusive and proportionate to the actual level of risk. They should also take into account the market position of the BBC’s commercial subsidiaries, market norms, and the role of the BBC Board in overseeing commercial

effectiveness and ensuring compliance with the commercial criteria. The BBC is concerned that Ofcom has not sufficiently taken these factors into account in its draft proposals. We suggest ways in which the proposed requirements could be modified.

- I.10 First, if Ofcom regards its jurisdiction as confined to adverse impacts on competition in UK markets, then the proposed regulatory requirements should not apply to any BBC commercial subsidiary that operates exclusively in markets outside of the UK.
- I.11 Second, Ofcom's starting position that the BBC must not provide public service information to its subsidiaries unless it is also available to the wider market does not seem to have taken into account the established structural separation between the two and the market norm for strategic alignment. It would be more reasonable, in our view, to start from a position where the BBC's subsidiaries do have access to BBC public service information that supports delivery of Group strategic objectives, provided it presents no risk of unfair advantage or market distortion. Similarly, it is not clear, in terms of proportionate protection against unfair advantage, what would be gained from Ofcom's suggestion that subsidiary boards' membership should be largely separate from the BBC Board.
- I.12 Third, Ofcom's proposed requirement that the BBC should routinely report quarterly financial performance information for each line of business feels disproportionate to the risk of cross-subsidy. Within the UK, the level of disclosure by the BBC's commercial subsidiaries is already at least in line with comparable players— and in many cases provides substantially more transparency. It is reasonable that there should be requirements on the BBC to inform Ofcom of the rates of commercial return that have been set and for mechanisms to be in place to ensure that the regulator is made aware when the rates are not being met. However, given the BBC will have effective protections and checks in place against cross-subsidy and given Ofcom's ability to take action if it is not satisfied with these, the additional proposed requirements look overly prescriptive.
- I.13 Fourth, Ofcom's final requirements should make clear that the BBC will normally supply goods and services externally only where not to do so would

risk distorting fair competition. The BBC agrees that it should charge its commercial subsidiaries at the same price if it makes the same goods or services available to third parties to ensure a level playing field. But where the BBC is setting prices for assets and services that it supplies only to its subsidiaries, there is no real justification for the BBC to do so as if selling to the wider market. Similarly, it should be clear that the BBC should only have to avoid exclusive supply to the subsidiaries where it would distort the market to do so.

- I.14 Finally, the Framework Agreement's definition of material changes in relation to commercial activities is cumulative. The first of the two questions – whether a change constitutes a new type of activity or a significant change to the commercial arm– is largely factual. The second should look at whether the proposed change would also, as a result of the relationship of the activity with public service activities, create a significant risk of market distortion or the creation of an unfair competitive advantage. We would like to discuss with Ofcom how they will balance the level and timing of any third-party consultation they consider necessary to inform these questions with appropriate commercial confidentiality. The process should not mean the BBC's commercial subsidiaries and their potential partners are required to operate in the market with a built-in disadvantage if, for example, they are required to release sensitive details of a potential new joint venture in advance.

2 Introduction

- 2.1 The BBC welcomes the opportunity to comment on the draft requirements Ofcom proposes to place on the BBC to avoid the relationship between the BBC's commercial and public service activities distorting the market or creating an unfair advantage. The BBC also welcomes the opportunity to comment on Ofcom's draft proposed procedures to assess material changes to the BBC's commercial activities.
- 2.2 The new oversight arrangements for the BBC's commercial activities are set out in the Charter and Framework Agreement¹. It will be the responsibility of the BBC Board to set the strategy and governance arrangements for the BBC's commercial activities and to assess the effectiveness of those activities. The BBC Board will also be responsible, in the first instance, for assessing proposed material changes to the commercial activities against the four commercial criteria, reflecting its duty to act in the public interest.² Under the Charter and Framework Agreement, Ofcom is required to regulate the BBC's commercial subsidiaries to ensure they do not distort the market. It is important that the specific requirements set by Ofcom are clear, proportionate, and targeted only at cases where action is needed.
- 2.3 The BBC agrees with Ofcom that, in deciding whether to open an investigation into whether the BBC is complying with the proposed requirements, it should look for evidence of cross-subsidy and whether 'the BBC's arrangements are outside the market norms for the relevant line of business'³. This is critical because the BBC undertakes commercial activities in many different areas where operational practices and financial expectations vary considerably depending on market conditions.
- 2.4 Although the opening section of Ofcom's consultation document articulates a focus on the impact of the relationship between the BBC's commercial

¹ BBC Charter and Agreement, 2016 - <https://www.gov.uk/government/publications/bbc-charter-and-framework-agreement>

² Ofcom, *The BBC's commercial Activities: A consultation on Ofcom's proposed requirements and guidance*, December 2016, paragraph 1.12

³ Ofcom, *The BBC's commercial Activities: A consultation on Ofcom's proposed requirements and guidance*, December 2016, paragraph 1.22

activities and public services on UK competition and on the need to take into account relevant market norms, it is not clear that these principles have been fully reflected in Ofcom's proposals on the draft requirements. The BBC also has a concern that, in some instances, the proposed requirements are overly prescriptive.

- 2.5 The BBC would argue that the new arrangements should recognise the importance, and appropriateness, of strategic alignment between the BBC's public service and commercial activities, to ensure the latter fits with and supports the BBC's mission and public purposes.
- 2.6 The BBC's existing ex-ante controls on trading and separation are rooted in established state aid principles. In short, these are designed to ensure the BBC's public funds do not confer an unfair advantage on its commercial arm (or any commercial third party) and so lead to market distortion. Apart from these legitimate constraints, the BBC aims to operate in line with the normal market practices of comparable vertically integrated media businesses.
- 2.7 These guiding principles are essential to secure a level playing-field for the BBC's commercial activities in what are highly competitive global markets, while also recognising that proportionate and targeted controls must be in place to avoid a risk of market distortion. Or put another way, the presumption should be that the BBC is able to operate according to market norms unless there is a risk or evidence of harm, as defined by the Charter and Agreement.
- 2.8 In the rest of this document, we set out the market context for the BBC's commercial activities and how the relationship between the BBC's Public Service Group and commercial activities is governed by well-established, legally-tested principles. In the final section, we suggest how Ofcom's proposed requirements and guidance might be modified in specific instances.

3 Market context

- 3.1 The BBC currently undertakes all its commercial activities through three principal subsidiaries: BBC Worldwide, BBC Studioworks and BBC Global News. From April 2017, there will be a fourth subsidiary, BBC Studios.
- 3.2 The model of a parent company with control over production, broadcast and distribution assets is increasingly typical of the media markets in which the BBC's commercial activities operate. The BBC's largest UK and international private sector peers are typically vertically integrated, enabling them to access, control and monetise content through their own production and distribution assets. While there have been many recent examples of media companies acquiring or building production and distribution assets to create more integrated content businesses, no major companies have looked to divest their distribution assets for some time⁴. Market trends are leading to further integration (both vertical and horizontal) – and those companies which do not own content are working to increase their control of the value chain.
- 3.3 As Ofcom acknowledged in its 2015 *Review of Public Service Broadcasting*, the PSBs including the BBC operate in these fast-changing, growing markets: 'The UK's creative sector, and the PSB system, are operating in an increasingly global context. The full effect of the acquisition of UK broadcasters and production companies by international companies, the increasing opportunities for the global exploitation of content and, in particular, the impact of new online players is not at this stage clear.'⁵
- 3.4 It is clear, however, that the changing market context means that the BBC's relative scale in most of the UK market areas where it operates (let alone in overseas markets) is diminishing rather than increasing. Taking into account revenue from its commercial subsidiaries, the BBC is smaller than many of the global media operators it competes with. The BBC's production and

⁴ Examples include: AMC Networks acquisition of Chellomedia; Sky's expansion of Vision; NBC Universal - itself owned by Comcast - acquisition of Dreamworks Animation; and ITV's re-organisation into ITV Studios with acquisition of additional production capability both in the UK and abroad.

⁵ Ofcom, *Public Service Broadcasting in the Internet Age*, July 2015, para 2.2, p6
https://www.ofcom.org.uk/_data/assets/pdf_file/0025/63475/PSB-statement.pdf

distribution businesses operate in competitive, global markets with rivals who are often backed by well-funded parent groups and/or are part of a strategically integrated supply-chain. The BBC's commercial businesses are adapting to remain competitive in this environment. For example, BBC Worldwide has partnered with AMC Networks Inc in relation to BBC America to create a larger channel group in the face of consolidating cable operators.

3.5 Looking at the BBC's subsidiaries within their particular relevant market contexts, it is clear that they do not occupy positions that would normally raise competition concerns. For a company to occupy a dominant position, it must have a position of economic strength which enables it to prevent effective competition being maintained on the relevant market by affording it the power to behave to an appreciable extent independently of its competitors, its customers and ultimately of consumers. None of the BBC's commercial subsidiaries are in such a position in the UK or in the global markets in which they operate.

3.6 Ofcom's report on content production in December 2015 demonstrates that the television production sector in the UK is competitive⁶, such that BBC Studios will be constrained in its ability to act independently of its customers, competitors and ultimately consumers. Barriers to entry are low and there has been significant new entry and expansion for a number of years. Independent analysis, submitted to the BBC Trust as part of its approval of BBC Studios,⁷ estimated that the entity's share of total UK TV commissioning spend is unlikely in the foreseeable future to exceed 13% (roughly what it is today).

3.7 We are continuing to see linear erosion in many developed markets where BBC subsidiaries operate. For example, linear pay-TV revenues in mature markets are plateauing, and subscriber numbers are forecast to decline in some digitally-advanced markets. Channel distributors (particularly smaller

⁶ Ofcom, *BBC Content Production Options, Ofcom's advice to the Secretary of State for Culture, Media and Sport*, December 2015, see para 3.13

https://www.ofcom.org.uk/_data/assets/pdf_file/0022/83083/bbc_content_production_options.pdf

⁷ BBC, *BBC Studios 4CC Main Case*, August 2016, p 85,

http://downloads.bbc.co.uk/bbctrust/assets/files/pdf/our_work/bbc_studios/2016/bbc_submission.pdf

players that lack the scale to participate in the advertising market in a big way) are under pressure. Content costs are increasing and carriage negotiations are increasingly challenging. While there are signs of subscriber growth in emerging economies, this is typically in basic tiers; BBC Worldwide's channels are typically in premium or thematic tiers.

- 3.8 The number of global homes using an SVOD service has been forecast to more than treble in the next few years, growing from 117m in 2015 to 428m by 2021⁸. The largest SVOD providers have indicated that future strategies will prioritise their own content rather than relying on third parties. As these providers' production expertise and global footprint strengthens, content distributors are likely to find it difficult to replace revenues from content sales to SVOD customers (a large driver of recent growth).

⁸ Research and Markets, *Global SVOD Forecasts*, December 2016
http://www.researchandmarkets.com/research/n52p69/global_svod

4 BBC's established practices

4.1 The BBC accepts that the relative scale of its commercial activities is not sufficient to guard against an unfair competitive advantage or distortion of the market. The BBC's commercial activities should operate in a way which minimises those risks. The BBC already has a well-established separation and trading framework which is rooted in state aid principles and EU/UK competition law. The aim of the framework is to ensure that the BBC's public funds do not confer an unfair advantage on the BBC's commercial activities resulting in market distortion, while allowing the BBC to stay in line with relevant market practices and to maintain strategic alignment between its publicly-funded and commercial activities. We have summarised below the main elements of this framework.

4.2 **Operational separation** - The framework is guided by the European Commission's *Broadcasting Communication* which states that: 'functional or structural separation of significant and severable commercial activities' should be considered best practice⁹. As a result, the BBC maintains financial and organisational separation between its public service and commercial activities – its subsidiaries operate at arm's length with no public service subsidy or underwriting of their activities. In particular, there are separate boards for the BBC and each of its subsidiaries. BBC employees below board level are normally accountable to either the BBC Public Service Group or a commercial subsidiary. As with market peers, strategic alignment between the BBC and its wholly-owned subsidiaries is vital in order to generate profits back to the parent, which in the case of the BBC, benefits licence fee payers. Therefore, the BBC shares data with its subsidiaries to support the delivery of the BBC's strategic objectives and mission, unless this would create a risk of market distortion, or is at odds with market norms.

4.3 **Supply of Goods and Services** – The BBC's approach is based on the state aid principle that 'cross-subsidisation of commercial activities is not

⁹ *Communication From The Commission On The Application Of State Aid Rules To Public Service Broadcasting*, 2009, C 86 - http://ec.europa.eu/competition/state_aid/reform/broadcasting_communication_en.pdf

justified and constitutes incompatible State Aid¹⁰. In line with other vertically integrated companies, the BBC's subsidiaries need access to goods, services and information so as to deliver their functions effectively within the group and deliver benefit back to the parent. The BBC avoids exclusive access to goods and services where it would provide a selective advantage, for example if the input is critical to commercial rivals' ability to compete with the BBC's commercial subsidiaries – even if the good or service in question was fairly priced¹¹. However, absent such a risk of selective advantage, the BBC would not generally provide its goods and services more widely unless the Charter gives it a specific, industry-focussed mandate (for example, training), or it can be done within the parameters allowed in the Framework Agreement for public service commercial trading activities (for example, temporary spare capacity dealing). These rules severely constrain the extent to which the BBC can undertake commercial activity from within the Public Service Group. The BBC also needs to take into account any wider restraints that might apply to sharing services externally, such as obligations to rights holders.

4.4 Transfer Pricing – The BBC's framework is designed to ensure that the BBC's relationship with its commercial subsidiaries operate in line with market norms and reflects the *Broadcasting Communication's* approach to fair allocation of costs¹². This approach applies for any area where the BBC is acquiring goods or services from its own subsidiaries; these will be subject to market testing and/or benchmarking where market testing is not feasible. The aim is to ensure that the BBC is not paying above market norms for the goods or services it is securing from its subsidiaries. The move to opening up the majority of BBC TV commissioning to fair and reasonable competition is clearly a major market testing exercise in itself¹³.

4.5 The BBC also has transactional relationships with its subsidiaries where it provides access to goods or services. Where BBC commercial subsidiaries make use of BBC corporate functions (for example, HR, Finance, Property,

¹⁰ *Communication From The Commission On The Application Of State Aid Rules To Public Service Broadcasting*, 2009, C103

¹¹ An example of this would be exclusive access to archive for a programme where production companies are bidding against BBC Studios to make that programme

¹² *Communication From The Commission On The Application Of State Aid Rules To Public Service Broadcasting*, 2009/C 257/01

¹³ BBC Framework Agreement, 2016, Schedule 3, C7 (1) and (2)

etc.) which are not shared outside the BBC Group, these are recharged at cost (i.e. allocation of direct costs and appropriate overheads). Where goods or services are made available to other comparable market participants, the same price is applied to the BBC's commercial subsidiary as would be offered to such third parties to ensure a level playing field. For the majority of inter-group transactions, the BBC uses Service Level Agreements (SLA) to ensure clarity and consistency about what is included within the price charged.

4.6 Commercial Rate of Return - All the BBC's commercial subsidiaries must be commercially efficient on an ongoing basis. Commercial efficiency is judged by reference to the market in which the subsidiary in question operates and takes into account relevant strategic benefits that comparable market operators would recognise. The existing test for commercial efficiency is that each BBC commercial service: 'must demonstrate that they are behaving as a market operator would to deliver financial return and strategic value [and] must generate a long-term return on investment to the BBC which is considered appropriate to the relevant market.'¹⁴ In order to monitor whether this is being delivered, the BBC has set an annual commercial efficiency baseline for each commercial subsidiary, taking into account relevant market conditions.

4.7 Transparency, Monitoring & Reporting – The BBC aims to strike a balance between transparency and the need for its subsidiaries to operate efficiently and in a way that does not put them at a competitive disadvantage. In considering what information to release, when and to whom (e.g. the regulator and/or the public), the BBC also has to take account of potential harm to the commercial interests of its commercial partners and contributors, particularly when projects are in development. Nevertheless, the BBC meets higher transparency standards than are required of its commercial peers. The BBC's Fair Trading Guidelines, which set out the principles it applies to transfer pricing and to the relationship between public service and commercial activities, are published.¹⁵ The BBC Annual Report reports on compliance with these guidelines and the BBC undertakes an

¹⁴ BBC Trust, *Strategic Framework for the BBC's Commercial Services*, February 2015, p5 - http://downloads.bbc.co.uk/bbctrust/assets/files/pdf/our_work/commercial/commercial_framework/strategic_framework_commercial.pdf

¹⁵ <http://www.bbc.co.uk/aboutthebbc/insidethebbc/howwework/policiesandguidelines/fairtrading.html>

annual Fair Trading Audit. The BBC is adopting additional transparency measures following the Trust's recent review of transfer pricing, for example, publication of a compliance report on the BBC website.¹⁶ On occasions, the BBC has identified the need to offer additional reassurance to the market through further disclosures. For example, the published proposals on BBC Studios contained details of transfer pricing methodologies for key areas such as staff, facilities and equipment, and property¹⁷. The BBC is happy to discuss with Ofcom the extent to which it could offer greater transparency about the relationship between commercial and public service activities without jeopardising the ability of the former to operate effectively in the market, a consideration of which is highlighted in the Charter and Agreement.¹⁸

¹⁶ http://downloads.bbc.co.uk/aboutthebbc/insidethebbc/howwework/policiesandguidelines/pdf/fairtrading_compliance_report_q1_q2_201617.pdf

¹⁷ BBC, *BBC Studios 4CCs Main Case*, August 2016

¹⁸ Framework Agreement, 2016, C28(b)(ii)

5 Response to Ofcom's proposed requirements and guidance

5.1 As stated in the Introduction, the BBC understands that the current regulations and procedures must be revised and updated to reflect the provisions of the new Charter and Framework Agreement. It is important that Ofcom's regulatory requirements are principle-based, non-intrusive and proportionate to the actual level of risk observed. They should also, in our view, take into account the market position of the BBC's commercial subsidiaries and the necessity for them to operate, as far as possible, in line with market norms, and also the role of the BBC Board in overseeing commercial effectiveness and ensuring compliance with the commercial criteria. The BBC is concerned that Ofcom has not sufficiently taken these factors into account in their draft proposals for the new requirements. We set out below how the proposed requirements could be modified in specific respects.

5.2 **Geographic Scope** (Paragraphs 1.16 and 1.22)¹⁹ The BBC notes that Ofcom does not expect to consider distortion to competition from the BBC's commercial activities in international markets. If Ofcom regards its jurisdiction as confined to adverse impacts on competition in UK markets, then it should follow that the proposed regulatory requirements – the purpose of which is to prevent market distortion in the UK - should not apply to any BBC commercial subsidiary that operates *exclusively* in markets outside of the UK. The BBC would continue to ensure that all its commercial subsidiaries meet the commercial criteria.²⁰ However, the imposition of additional regulatory requirements, for example on reporting, will likely create costs and, therefore, should only be applied where appropriate and justified.

5.3 **Lines of Business** (Paragraphs 3.40-3.64) – Ofcom states it will apply many of the proposed requirements, such as financial reporting, by 'line of

¹⁹ All paragraph and page references in this section are from Ofcom, *The BBC's Commercial Activities: A consultation on Ofcom's proposed requirements and guidance*, December 2016

²⁰ Framework Agreement, 2016, C23(5)&(6)

business.’ Ofcom suggests that the BBC must propose how it will define ‘line of business’ for each commercial subsidiary but it is not clear what Ofcom means by this term and the level of granularity it has in mind. The BBC’s commercial subsidiaries publish reports and accounts each year which contain comprehensive financial information. The level of disclosure is at least in line with comparable players in the UK market – and in many cases provides substantially more transparency. The BBC would, of course, provide additional information on the commercial activities if Ofcom requires it to carry out its regulatory functions but it would want to avoid a situation of dual accounting and reporting against different definitions. We would welcome further discussions with Ofcom on this matter.

5.4 **Operational Separation Requirements** (Paragraphs 3.19-3.24) - Ofcom’s starting position is that 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’ (p.12). Given the established structural separation between the BBC and its subsidiaries and the market norms for strategic alignment, it would be more reasonable to start from a position where the BBC’s subsidiaries do have access to BBC public service information that supports delivery of strategic objectives within the BBC Group, provided it presents no risk of unfair advantage or market distortion. It would be helpful therefore if, in discussing what public service information the commercial subsidiaries can have access to, Ofcom’s requirement should take into account what is ‘reasonably’ required rather than what is ‘strictly’ required to ensure the commercial activities fit with the mission and public purposes, or the fulfilment of an existing commercial relationship (p12).

5.5 The BBC would welcome clarification from Ofcom about the reason for the suggestion that subsidiary boards should ‘consist of an appropriate number of directors with an emphasis on those who are separate from the BBC Board and its executive committees’ (p.12). The current Board of BBC Worldwide does have considerable overlap with the BBC Executive Board because its non-executive positions are filled by BBC Executive Board non-executives

and executives. While it may be possible to change the make-up of the Worldwide Board, it is not clear what would be gained in terms of proportionate protection against unfair advantage. The BBC has well-established separation mechanisms in place (as set out above) and, in terms of normal group strategic alignment, it makes sense that the commercially well-qualified BBC non-executives also serve on the Worldwide Board.

5.6 **Commercial Rate of Return** (Paragraphs 3.40-3.53), and **Monitoring, Reporting and Transparency** (Paragraphs 3.54-3.64) - A similar concern about proportionality applies to Ofcom's proposals that the BBC assess and report on an 'appropriate rate of return for each line of business' (p.17). It is consistent with state aid rules that a publicly-funded organisation such as the BBC should not be able to subsidise a failing business so as to give them an unfair competitive advantage and, as a result, distort the market. The BBC will have effective checks in place to ensure this does not happen. It is also reasonable that there should be requirements on the BBC to inform Ofcom of the rates of return that have been set and have mechanisms in place to ensure that the regulator is made aware when a rate of return is not being met. However, Ofcom's requirement that the BBC should routinely report quarterly performance against the expected commercial rates of return (amongst other financial information) for each line of business goes further than this. While this level of financial reporting may have been appropriate for the Trust for the purpose of corporate governance and strategic control, it is unclear why it is necessary or proportionate for the purpose of regulatory oversight.

5.7 In setting requirements to ensure that the BBC is not undertaking a commercial activity that is operating outside market norms in terms of its commercial return, Ofcom should, in the BBC's view, take account of:

- The level of a baseline reasonable rate of return for each commercial subsidiary which a market operator would find tolerable. This will vary from market to market, may change over time and will be based on a longer-term view of performance and market developments. It will also take account of strategic advantages for the group as a whole that a rational market operator would consider relevant to assessing commercial performance; and

- Any point at which there is good reason to believe that a BBC subsidiary as a whole is falling below this baseline. An efficient market operator may, as Ofcom recognises in its proposals, accept variable returns within its business, or parts of it, for a variety of rational, strategic reasons. Where a BBC commercial subsidiary is not being ‘subsidised’ in terms of its overall commercial rate of return or the terms of access to licence-fee funded goods and services, it should be free to make comparable commercial judgments.

5.8 Accordingly, the requirements for the BBC Board to ‘Assess what an appropriate rate of return is for each line of business’ and to ‘Inform Ofcom where a line of business is not making a commercial rate of return’ (p.17) appear reasonable and consistent with Ofcom’s regulatory duties. However, the other proposed requirements seem overly prescriptive in directing how the Board should behave, and are unnecessary to address the level of risk²¹. Ofcom has sufficient enforcement powers to take action if it is not satisfied that a subsidiary is earning a commercial rate of return, or that the BBC’s has addressed it over time.

5.9 **Supply of goods and services and transfer pricing requirements (3.25-3.39)** - Ofcom states that: ‘Where the BBC public service supplies goods and services to the wider market, [the BBC must] make these available to third parties on equivalent terms and prices to those offered to its commercial subsidiaries’ (p.14). As set out above, the BBC agrees that it should charge its commercial subsidiaries at the same price if it makes the same goods or services available to third party production and or distribution companies to ensure a level playing field.

5.10 However, we consider that Ofcom’s final requirements should be modified to make clear that the BBC will normally supply goods and services externally *only* where not to do so would risk distorting fair competition, and in a way that enables the BBC to demonstrate it is earning a market participant’s acceptable rate of commercial return (consistent with existing state aid principles).

²¹ Ofcom, *The BBC’s commercial Activities: A consultation on Ofcom’s proposed requirements and guidance*, December 2016, p.17.

- 5.11 Specifically, Ofcom proposes that the BBC must: 'Set pricing for goods and services supplied by the BBC public service whether sold to the BBC's commercial subsidiaries or to third parties, as if they were sold on the open market' (p14). The BBC does believe this requirement is proportionate or necessary. Where the BBC is setting prices for group assets and services that it supplies only to the subsidiaries, there is no justification to require the BBC to do so as if we were selling to the wider market. BBC Group assets and services are either procured at market rates or tend to be BBC-specific and do not lend themselves to meaningful market-comparison (for example, access to BBC sets or props or specialist advice on BBC standards). If the aim is to avoid cross-subsidy, it is essential only that the cost (including direct costs and an appropriate share of overheads) is passed on to the subsidiaries based on their use. The BBC considers that this is line with market norms and should be recognised in Ofcom's final requirements and guidance. Where it would distort the market for such supply to be exclusive, then the BBC would, of course, have to set an external rate for access which delivered parity between its commercial subsidiaries and third parties competing in the same market. We would be happy to share further information on these areas with Ofcom.
- 5.12 Later in the consultation document, Ofcom suggests that the BBC Public Service must make goods and services supplied to the commercial subsidiaries available to the wider market and can only engage in exclusive supply where there is a clear reason or where it is to aid operating efficiency (3.29 and 3.30). The BBC understands that the objective is to avoid creating an unfair advantage for the commercial subsidiaries, but it would be more reasonable to word these requirements in a way that presumes that the BBC can restrict access to group assets and services to the BBC Group, unless it would distort the market to do so. Where it is essential that third parties have access to be able to compete on a level playing field with the BBC's commercial subsidiaries, access should be made available on the same terms for all such third parties. Those terms should be set in a way that does not distort any wider supply market for comparable goods or services.
- 5.13 In paragraph 3.34, Ofcom highlights its expectation that the BBC should 'use market benchmarking to value secondary and ancillary rights of its originated content'. The BBC has historically used an 'open offer' process to ensure that

the Public Service was paid market rates for the secondary rights it sold to BBC Worldwide. This was a valuable mechanism for guarding against market distortion at the boundary between the BBC's public service and commercial activities.

5.14 Under the new Charter, the BBC will buy programmes via a fair competitive process from BBC Studios and external suppliers. BBC Studios will enter into commercial arrangements with BBC Worldwide or other distributors and there will no longer be a need to undertake a market benchmarking exercise, which would be an unnecessary duplication of genuine competition.

5.15 **Material changes** (Section 4) – The BBC welcomes Ofcom's confirmation that, in line with the Charter and Framework Agreement, they will not consider a proposed change to the commercial activities to be material if there is no significant risk of it distorting the market or creating an unfair competitive advantage. The BBC is required to publish a policy on how it will, in the first instance, determine and assess material changes. We will do so in due course.

5.16 The Framework Agreement defines a 'material change' to commercial activity as:

“(a) the carrying out of a new type of activity as a commercial activity (for example, an activity previously carried out as a UK public service, non-service activity or trading activity); or

(b) a significant change to the BBC's commercial arm,

where (c) there is a significant risk that the change may, as a result of the relationship of the activity with the UK public services, trading activities or non-service activities, distort the market or create an unfair competitive advantage”²²

5.17 This is a cumulative test where both a) and c), or both b) and c) must be met. We would suggest therefore that any materiality determination is approached as a two-stage process. Whether a proposal involves the carrying out of a new type of activity as a commercial activity should largely be a

²² Framework Agreement 2016, C23(14)

factual question. Having said this, the BBC would not normally expect a proposal to be considered a 'new type of activity' or a 'significant change' if it was the natural development of the BBC's core commercial activity, namely the exploitation and distribution of BBC TV content, in response to technology or audience change, and in those areas where BBC commercial activity is already materially present - as opposed to the BBC entering into wholly new markets.

5.18 In those cases where Ofcom determines that a proposed change represents a) or b), it will need to assess whether the proposed change would also, as a result of the relationship of the activity with public service activities, create a significant risk of market distortion or the creation of an unfair competitive advantage. The primary consideration here should, in the BBC's view, be the relative scale of the activity in question and whether the proposal would create a new relationship between a commercial activity and the BBC Public Service that could distort the market.

5.19 As required by the Framework Agreement, the BBC's policy will include arrangements for consultation on proposed material changes with 'interested parties where appropriate'²³. It is important that the level and timing of any consultation is balanced with appropriate commercial confidentiality. The process should not mean that commercial subsidiaries and their potential partners are forced to operate in the market with a built-in disadvantage. For example, if the BBC is required to release advance details of a potential new joint venture with a commercial partner, it could put the BBC and the new joint venture at a significant disadvantage compared to other market operators. By releasing sensitive material early, the BBC could be unfairly compromising its negotiating position or giving competitors an unwarranted opportunity to create obstacles for the new venture. There may also be circumstances in which, in order to abide by the rules about the disclosure of market-sensitive information relating to listed companies, the BBC is not able to publish details of a planned change in advance. We would like to discuss with Ofcom their proposal to invite 'third party comments' during their initial assessment of materiality and how it can be ensured that this requirement

²³ Framework Agreement, 2016, C23(11)

does not have an unfair, negative impact on the normal running of the BBC's commercial activities.