



## **ITN submission to Ofcom consultation on BBC's commercial activities**

ITN welcomes the Ofcom public consultation and is grateful for the opportunity to respond to this important examination of Ofcom's requirements around the BBC's commercial activities. ITN's chief focus is how BBC Studios will operate within the independent production sector and how Ofcom will approach regulating its activities. As one of the UK's largest independent production companies we have a number of core concerns related to the launch of BBC Studios and its potential impact upon this vital sector. These relate in particular to possible market distortion, transparency of transfer pricing and cross subsidy of a new commercial entity. The guidelines and principles that Ofcom implements for existing BBC commercial entities must be applicable to the new BBC Studios structure.

Summary of key points:

- Annual assessment of BBC commercial activities required to prevent material changes to activities
- Complete transparency is required regarding trading and separation of all Commercial entities – particularly the newly-formed BBC Studios to avoid cross-subsidy from BBC PSG and ensure fair pricing
- A recent EY report has shown the current commercial subsidies (Worldwide, Global News Ltd and Studioworks) have operated under inconsistent and poorly recorded transfer pricing deals – which sets a worrying precedent for a future BBC Studios. We seek further clarification of how this will be avoided in future

### **About ITN:**

ITN has diversified its business and broadened the range of our activities, into profit-generating commercial enterprises alongside our core news contracts for ITV, Channel 4 and Channel 5, creating ITN Productions, the creative and commercial arm of ITN. In addition to broadcast programming we make television commercials, branded content, corporate filmmaking, and digital and broadcast news, entertainment and sports clips and programmes. Our broadcast output ranges from current affairs programmes, factual entertainment and popular factual programmes to fast-turnaround factual. In the last year we have made programmes for every major UK channel, including a successful BBC One daytime format *Going Back Giving Back* and a specialist factual programme *The Great Butterfly Adventure* for BBC Four. We have also had success internationally, including a recommission, *Killer Instinct* with Chris Hansen, on Discovery ID and a sporting competition for US veterans, *Triumph Games* broadcast on CBS Sports.

*As a supplier to the BBC we are interested in opportunities as part of a more open commissioning process but are also alert to any unintended consequences for the open market that might arise through the BBC Studios.*

ITN has significant concerns particularly related to market distortion and fair trading. *These are detailed in full below.*

### **The proposed commercialisation of BBC Studios:**

Under proposed plans to create a commercial BBC Studios, ITN Productions would compete directly with BBC Studios for television commissions both from the BBC and other national and international broadcasters. Any commercialisation of BBC TV production must be on a strictly level playing field so as not to imbalance the strong commercial media sector which is of huge creative and commercial benefit to the UK.



ITN welcomes the proposal of an open market and the opportunity to pitch for all commissions within the BBC – however, there are a number of issues that this strategy does not address.

### **Trading and separation requirements**

ITN agrees with Ofcom's proposed duties to set "trading and separation rules" to ensure appropriate separation between BBC PSG and any commercial subsidiaries. However, we confirm that while it is vital to have separate commercial subsidiaries within the BBC to create the structure for commercial operations this does not address all competition concerns – which require additional operational safeguards.

### **Potential competition concerns include:**

#### **Information exchange:**

ITN recognises that it will be very difficult to track and even prevent the exchange of information potentially being exchanged between BBC PSG and commercial subsidiaries. Ofcom recognises that there will be a flow of information that may include beneficial commercial intelligence from BBC PSG into commercial subsidiaries but it is unclear how that information could be ring-fenced within a specific department for a specific use for "one time only". We would support specific governance arrangements which would provide distinct representatives for commercial entities versus public service board members.

#### **Supply of goods and transfer pricing:**

This is perhaps the single biggest concern of the independent production sector regarding BBC Commercial entities. We require clear reassurance that all goods and services from the Public Service Group are provided at arms lengths commercial terms to all subsidiaries. This reassurance can only be achieved with transparency – public transfer pricing of all goods and services. This cost-based approach as advocated by Ofcom, which ITN supports, will only work if it is publicly available.

**Infrastructure:** From an infrastructure perspective, when talking about the location of BBC Studios the initial BBC Studios proposal document stated it is "likely to build on existing in-house production centres of excellence wherever it can". This could be unfairly beneficial to the new entity for several reasons.

Firstly, existing investments were made with the backing of the BBC: a well-funded and secure organisation with significant buying power. It is possible that discounts were offered that would not be made available to other organisations.

Secondly, the size, longevity and security of BBC funding would have enabled investment in facilities other production companies could not have justified. As such the range and/or specification of facilities may exceed those at other organisations.

Finally, it is currently unclear how costs associated with such investment would be transferred to the new entity, and what measures would be put in place to ensure such transfer was managed fairly.

It seems likely, therefore, that BBC Studios will benefit from sharing facilities that are being used by other elements of BBC in-house production. Without further information about the funding platform for BBC Studios it is not evident whether the licence fee payer will in effect be subsidising the BBC to make content for commercial gain.



The proposal states (p61) that BBC Studios “will not own property, studios or equipment beyond some very limited post-production software and equipment and capture assets. The initial transfer of assets will also involve the transfer of significant liabilities. BBC Studios will have access to BBC Group facilities and assets and further detail on how this access will be fairly priced in line with Fair Trading principles is set out below. The BBC will not however be maintaining assets within the Public Service exclusively for the use of BBC Studios.”

The BBC Trust’s Review of Transfer Pricing Arrangements already found examples of inconsistency in terms of pricing across BBC departments. BBC Studios, which will be the biggest independent production company in the UK, is surely the only one of its size that has no requirement to invest in infrastructure or systems – relying on “renting” from the public service group. Without full transparency it is unclear whether internal BBC pricing for this service may be very different to market prices.

Therefore the “appropriate contribution” for overheads and capital costs as laid out by Ofcom must be transparent.

There must be complete transparency around pricing, asset transfers and service charges – need for commercial terms at market pricing. This can be broken down into the following competition concerns:

**Brand Licence Agreement:** A October 2016 EY report for BBC Trust found that BBC Global News Ltd has not been paying a royalty for the use of the BBC brand, until it was corrected very recently, under the existing licensing agreement. The BBC has since agreed to determine a new royalty rate by the end of the current financial year. The BBC brand is incredibly powerful and BBC Studios should pay for the use of it. We would seek reassurance that a licensing agreement between BBC Studios and the public service group is transparent and at market rate. EY themselves observed that “under normal commercial agreements it would be unusual for the owner of a piece of intellectual property to allow continued exploitation by a third party in return for no payment over a prolonged period”. The BBC has also said it will review the Worldwide brand licence to ensure consistency of approach across commercial subsidiaries.

We support Ofcom’s call that the BBC must publish the methodologies it uses for valuing the BBC brands.

**Benchmarking BBC Studios production costs:** Any cross subsidy of BBC Studios production by the BBC would enable Studios to undercut external production companies. It seems reasonable to expect that BBC Studios will benefit from BBC infrastructure – accommodation, facilities, centralised staffing resources such as legal, compliance and human resources etc. Contribution towards these overheads should form part of the BBC Studios cost base and be reflected in pricing and tariffs.

There is also the question of how to benchmark the value/cost of BBC Studios productions to the BBC in terms of the legacy infrastructure that it may benefit from. This means that by definition BBC Studios is not competing on a level playing field with other competitors. There would have to be absolute transparency in terms of pricing so that it is clear to the industry that there is no inbuilt advantage or subsidising for BBC Studios and that its costs are benchmarked with the rest of the industry.

The BBC states: “Access to equipment, facilities, technology, archived materials and core services in the public service for BBC Studios will be governed by the Fair Trading Guidelines and charged under the BBC’s existing transfer pricing methodology as set out in those guidelines.”



In a recent EY transfer pricing report for the BBC Trust they found that there was insufficient regular contract review amongst its existing commercial subsidiaries – Global News, Worldwide and Studioworks which "might create the risk of entrenching behaviour that may not be consistent with market practice".<sup>i</sup>

The BBC Trust was due to review transfer pricing methodology last autumn so it is not clear whether the existing pricing methodology is relevant to use as a benchmark. It is vital for all updated methodologies for transfer pricing of all services are publicly available.

**BBC Studios programmes for the BBC:** It must be demonstrated there is no cost difference between programmes made for the BBC by BBC Studios and the cost of programmes made by BBC Studios for other broadcasters – ie. that BBC Studios provides a cheaper commissioning quote for BBC programmes.

ITN is keen to understand how the playing field can be equal when a BBC in-house production company (albeit commercial) pitches to its own broadcaster with which it shares infrastructure, kit and software – to which it is separate but still intrinsically linked?

ITN would also be interested to explore the benefits to both the sector and to audiences of a proposed cap of 50 per cent for the amount of BBC Studios programming provided to the BBC. This would ensure a plurality of output for the BBC and maintain a diverse slate for audiences.

**Fair pricing for programmes:** The BBC Studios proposal document suggests abiding by an existing BBC tariff system for pricing programmes to benchmark the costs of BBC Studios programmes. A public tariff system demonstrating the cost of the BBC's own internal content would enable external production companies to understand how the pricing is set.

Absolute transparency is required here to see how the BBC prices programmes as well as how BBC Studios intends to charge for them. However, the wording around this in the Studios proposal is about "intention" rather than obligation and suggests that Commissioners will not be required to publish tariff ranges if they choose not to.

Since BBC Studios has not been implemented at this point the only other separate commercial entity that is connected to the BBC is Worldwide. The lack of transparency and poor record keeping around transactions and transfer pricing between the BBC and Worldwide demonstrates the risk of creating another commercial entity that has inadequate financial safeguards and processes.

A recent report for the BBC Trust by Ernst & Young found that there was inadequate record keeping of deals and inconsistency of pricing between BBC Public Service Group (BBCPSG) and BBC WorldWide (BBCWW). This demonstrates the difficulty of maintaining transparency around commercial arrangements between a commercial arm of the BBC and the Public Service parent. This underlines the utmost importance of all financial transactions between both BBC Studios and BBCPSG being recorded and independently audited – as well as any transactions between BCS and BBCWW.

In the executive summary of the Review of Transfer Pricing Arrangements BBC Trust Report, based on the findings of E&Y, it states: "there would be merit in improving record keeping and in transfer pricing activity being tracked more systematically by the Fair Trading Team". It went on to say "in some circumstances different approaches have been applied to similar transactions without providing a clear explanation as to why a consistent approach has not been used".

The review also stated: "While the Fair Trading Guidelines state that, under the cost-based pricing approach, "an appropriate contribution for reinvestment in the BBC's Public Service Activities is required", there is currently very little guidance as to what level this "margin" should be."

It concluded: "The reasoning behind setting the rate for BBC WW's brand payment is not clear, and there is a theoretical risk that some forms of rights deals by Worldwide may inhibit the transparency associated with the pricing of individual programmes."

All of these red flags in the report show that there is precedent for an ad hoc approach to financial practice, record keeping and accountability already between the BBC and its commercial arms. We would seek reassurance and process that this would not happen with a new BBC Studios – with all transfer pricing transactions recorded centrally.

**Discrepancies and different interpretation of Fair Trading guidelines are evident in the way content is paid for between Global News Ltd (GNL)-commissioned content and BBC News commissioned content, as well as co-commissioned content – see p18**

- a) For GNL-commissioned content, BBC News makes a payment to GNL via a discount for overheads and margin based on the secondary value BBC News derives from it.
- b) For BBC News-commissioned content the GNL payment is set at incremental cost.
- c) For the co-commissioned programmes analysed, it appears that BBC News pays all the overheads.

**This inconsistency does not set a positive precedent for commissioning of content from different sources from the BBC or by BBC Studios.**

- For the purchase of rights by BBC Worldwide, EY note (case study 12) that some payments are for bundled rights, in order to secure access to content. However they believe that this practice could create negative competitive effects in the market for this content, possibly pushing prices above competitive levels, or restricting further access. EY state that this could become a particular issue if this type of strategy becomes more prevalent.

### **Need for an independent review**

The BBC Trust had been tasked with "rigorously examining" arrangements for financial and operational separation between the BBC Public Service and BBC Studios and to impose safeguards where necessary as part of a regular "ex-post review". Clearly it is now down to Ofcom to scrutinise any separation of the two entities as part of any initial oversight of separation but also ongoing yearly reviews to make sure that there is no "scope creep".

The BBC proposal states (p17) that "The BBC will publish progress in its commitment to competition on an annual basis. This will show how much of the existing in-house guarantee has been made available to competition." This seems the correct way to ensure that process is being followed.

We agree with the BBC proposal that there should be regular reviews by the BBC's regulator Ofcom regarding the arrangements for securing separation between BBC Public Service and BBC Studios, the pricing and terms given by the BBC to BBC Studios in comparison to other external suppliers and the operation of the commissioning framework.

**The EY report recommends the possibility of a regulator or the BBC to publish an annual monitoring report on the arm's length agreements between BBC public service and its subsidiaries to review whether they are in line with the Fair Trading Guidelines. ITN proposes that Ofcom's agreed**



**Assessment of Materiality should be carried out annually. If any material changes are found to have occurred this would trigger the two-phase Trading and Separation assessment.**

**Core recommendations:**

In order that the BBC become more transparent and accountable in all its dealings ITN makes the following core recommendations:

- That every proposed new BBC service – such as BBC Studios - should be subject to a rigorous approvals process, including a market impact test **conducted by Ofcom**
- Publish an annual monitoring report on the arm's length agreements between BBC public service and its subsidiaries (including BBC Studios) to review whether they are in line with the Fair Trading Guidelines
- BBC to publish methodologies used to establish transfer prices for each type of good or service that the Public Service supplies to commercial activities.
- Publish methodologies for valuing BBC brands

**Conclusion:**

ITN is a strong supporter of the BBC as an important institution as well as a key player in the British and global media landscape. However, we strongly urge Ofcom to make sure that in this swiftly evolving media environment that the BBC is not permitted to expand beyond its remit and distort the commercial production market to the detriment of commercial businesses in this sector.

The ecology of the UK media landscape has created a flourishing industry and to disrupt it by subsidising commercial enterprises such as BBC Studios, using licence fee payers money, is to the detriment of both audiences and the media industry – an industry which thrives here and overseas.

ITN welcomes the BBC's proposal to open up commissioning quotas for BBC programming under the "compete and compare" strategy. However, since this is part and parcel of the BBC Studios proposal we require far more transparency from the BBC in terms of BBC Studios pricing and implementation plans to separate Studios financially from the BBC Public Service without it benefiting from cross-subsidy.

ITN is concerned that due to the timing of the Charter and Ofcom's new role, and necessary consulting period, that the newest BBC commercial entity, BBC Studios will continue to establish itself without having to adhere to required transparency around costings, simply because these have yet to be decided or clarified. The timing of BBC Studios' launch is problematic for the independent production sector because so much around the BBC's governance and regulation is in flux at present.

We echo the recommendations made by Ernst & Young specific to BBC Studios implementation – although these principles could be applied across all BBC commercial subsidiaries

1. Document, articulate and communicate transfer pricing procedures and outcomes to stakeholders, in order to ensure transparency and address industry concerns;
2. Be able to demonstrate the reasoning behind particular individual decisions – for example why a specific value has been used in setting payments;
3. Continue to place great importance to the benchmarking analysis and when possible use tendering process; and
4. Identify trigger points, or put in place a formal review process for long-term contracts.



The BBC has committed to a group trading manual for April 2017 for clear and consistent trading principles. This should provide further clarity and transparency related to BBC Studios and should be made publicly available.

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