



# The BBC's commercial and trading activities

Requirements and guidance

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## About this document

The role of the BBC is to produce high quality and distinctive programmes and services which educate, inform and entertain.

As a large publicly-funded organisation, the BBC inevitably has an impact on competition in the wider media market. It may have a positive effect by increasing choice, stimulating demand or encouraging sector wide innovation, for example. But in fulfilling its objectives, the BBC may also harm the ability of others to compete effectively.

The BBC may carry out commercial activities but only through subsidiary companies. There is a risk that without appropriate safeguards the BBC's public funding could be used to subsidise or benefit these subsidiaries by offering services on favourable terms. This could distort competition by giving its commercial subsidiaries an unfair competitive advantage. This document sets out the requirements and guidance we have put in place on the BBC to avoid this happening. It also describes the process that Ofcom will use to assess whether material changes to the BBC's commercial activities can go ahead.

Further, under the Charter and Agreement, the BBC Public Service is allowed to carry out some specific types of "trading" activity which are ancillary to its core public service activities and are commercial in nature. This document also sets out the requirements we have placed on the BBC to protect fair and effective competition in carrying out trading activities.

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## Section 1

# Introduction

- 1.1 The BBC's role is to act in the public interest and serve all audiences with content which informs, educates and entertains. To do so, it provides impartial news and information, together with high-quality and distinctive output and services. In resetting the BBC's Mission and Public Purposes,<sup>1</sup> the Government has confirmed the valuable contribution the BBC makes to the UK and to people's lives. The Government has also made clear that it expects the BBC to do more in certain areas, in order to justify its unique funding arrangements and privileged status.
- 1.2 As a large publicly-funded organisation, the BBC inevitably has an impact on competition in the wider media market. It may have a positive effect by increasing choice, stimulating demand or encouraging sector wide innovation, for example. But in fulfilling its objectives, the BBC may also harm the ability of others to compete effectively.
- 1.3 As well as acting in the public interest and serving audiences with content, the BBC also carries out certain "trading" activities that are commercial in nature. These involve the provision of goods and services to its own commercial subsidiaries, third parties and the general public. The BBC's commercial subsidiaries undertake commercial activities as described below.
- 1.4 Under the Royal Charter<sup>2</sup> and Agreement<sup>3</sup> – published by Government on 15 December 2016, the BBC must not directly undertake any commercial activities. However, it may carry out commercial activities through subsidiary companies if the activities:
  - a) fit with the Mission and Public Purposes;
  - b) are not funded by licence fee revenue; and
  - c) are undertaken with a view to generating a profit.<sup>4</sup>
- 1.5 At the time of publication, the BBC undertakes commercial activities through four commercial subsidiaries:<sup>5</sup>
  - BBC Worldwide, whose activities include investing in BBC productions and selling programmes and formats around the world;

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<sup>1</sup> Articles 5 and 6 of the Royal Charter for the continuance of the British Broadcasting Corporation.

<sup>2</sup> In the rest of this document we refer to the Royal Charter for the continuance of the British Broadcasting Corporation as the "Charter", available at <https://www.gov.uk/government/publications/bbc-charter-and-framework-agreement>

<sup>3</sup> The "Agreement" is used in the rest of this document to refer to the Agreement between the Secretary of State for Culture, Media and Sport, and the BBC, available at <https://www.gov.uk/government/publications/bbc-charter-and-framework-agreement>

<sup>4</sup> Charter, Article 7 (6).

<sup>5</sup> Where we refer to commercial subsidiaries, we mean the four commercial entities and any which may come into existence in the future. Where we refer to commercial activities, we adopt the definition contained in the Charter and Agreement.

- BBC Studioworks, which offers studio and post-production services;
  - BBC Global News, which operates the BBC's commercial international news TV channels and websites; and
  - BBC Studios, which produces programme content for the BBC and the wider market.<sup>6</sup>
- 1.6 The BBC's commercial subsidiaries exist to generate a return which can be reinvested in BBC programmes and services and supplement income from the licence fee. In order to carry out this role, the activities of the subsidiaries include the commercial exploitation of licence fee funded content and infrastructure. The commercial subsidiaries also have access to certain services and infrastructure such as shared business support services (for example, finance, legal, IT and HR).
- 1.7 There are therefore flows of funds and assets between the BBC Public Service<sup>7</sup> and the commercial subsidiaries given that the commercial subsidiaries, as separate entities, pay for operational services provided by the BBC Public Service. There are also less tangible non-trading relationships between the BBC Public Service and the commercial subsidiaries which include flows of information between the two.
- 1.8 Because of these relationships there is a risk that, without appropriate safeguards, the BBC's public funding could be unfairly used to subsidise or benefit its commercial subsidiaries, resulting in a distortion of competition in the UK. This could happen, for example, if the commercial subsidiaries obtained BBC services at below-market prices.
- 1.9 Although the Agreement prohibits the BBC Public Service from operating commercial subsidiaries, the BBC Public Service is permitted to undertake certain trading activities, which are characterised in the Agreement as activities that are commercial in nature, but are not to be treated as "commercial activities". Trading activities are ancillary to the BBC Public Service.
- 1.10 Trading activities encompass transactions between the BBC Public Service and: (i) its commercial subsidiaries; (ii) third parties; and (iii) the general public through direct provision of goods and services e.g. sale of tickets to BBC Public Service events.<sup>8</sup> We sometimes refer to the third parties and the general public as 'the wider market'. Other examples of trading activities include the leasing out of spare studio capacity or licensing the rights to BBC-produced DVDs. A full list of the types of trading activities, as set out in clause 31(2) of the Agreement, is provided at Annex 1.

## Role of the BBC and BBC Board

- 1.11 The Charter and Agreement place a number of obligations on the BBC regarding commercial activities carried out by its commercial subsidiaries. It must ensure that

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<sup>6</sup> In December 2016 the BBC Trust approved the BBC establishing BBC Studios as its fourth commercial subsidiary:

[http://downloads.bbc.co.uk/bbctrust/assets/files/pdf/our\\_work/bbc\\_studios/2016/bbc\\_studios\\_decision.pdf](http://downloads.bbc.co.uk/bbctrust/assets/files/pdf/our_work/bbc_studios/2016/bbc_studios_decision.pdf).

<sup>7</sup> References to the 'Public Service' or 'BBC Public Service' should be read as references to BBC's UK Public Services, trading activities and non-service activities.

<sup>8</sup> Our requirements do not include any free ancillary services provided by the BBC Public Service such as helplines or information pamphlets.

these commercial activities fit with its Mission and Public Purposes, are commercially efficient, do not jeopardise the BBC brand and do not distort the market or gain an unfair competitive advantage as a result of their relationship with the BBC Public Service. Together, these requirements are known as the commercial criteria.<sup>9</sup>

- 1.12 The BBC Board sets the overall strategy for the BBC's commercial activities as carried out by the commercial subsidiaries<sup>10</sup> and must also consider proposals for material changes to these activities and assess them against the commercial criteria.<sup>11</sup>
- 1.13 The BBC Public Service may carry out trading activities<sup>12</sup> and the Charter places a number of duties on the BBC in relation to these activities.<sup>13</sup> The BBC must have regard, amongst other things, to the competitive impact of these activities.

## Our role

- 1.14 Unlike the BBC Board, Ofcom's functions in relation to the BBC's commercial activities are limited to issues concerning the separation of the BBC Public Service and the commercial activities carried out by the commercial subsidiaries.
- 1.15 Ofcom has a responsibility to set out requirements on the BBC to ensure that the relationship between the BBC's commercial activities and the BBC Public Service does not distort the market or create an unfair competitive advantage.<sup>14</sup>
- 1.16 Where the BBC proposes to make changes to its commercial activities carried out by the commercial subsidiaries, including proposing a new activity, Ofcom must also assess whether the change is material and, if so, whether the BBC is able to proceed. Our assessment will focus on the relationship between the BBC Public Service and the commercial activities.
- 1.17 Under the Charter and the Agreement, Ofcom must also set out how it will regulate the trading activities and the procedures to be followed (including such requirements as Ofcom consider appropriate to protect fair and effective competition).<sup>15</sup>
- 1.18 In carrying out our role we will have regard to our general duties under the Communications Act and in particular to the requirement under Article 45(2) of the Charter to have regard to the desirability of protecting fair and effective competition in the United Kingdom.
- 1.19 We note that the Charter and Agreement do not give Ofcom a role in enforcing compliance with state aid law (state aid is a matter for the BBC and Government). However, there are clear parallels between the requirements imposed by Ofcom and state aid requirements.

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<sup>9</sup> Agreement, Clause 23 (5).

<sup>10</sup> Charter, Article 20 (3) (j).

<sup>11</sup> Charter, Article 20 (5).

<sup>12</sup> Which are defined in the Agreement, Clause 31 and replicated in Annex 1 of this document.

<sup>13</sup> Articles 9 to 17 in the Charter.

<sup>14</sup> Agreement, Clause 28 (1).

<sup>15</sup> Charter, Article 46(5) and the Agreement, Clause 32.

## Purpose of this document

- 1.20 This document forms part of the BBC's Operating Framework, and as such includes obligations which are binding on the BBC. It also sets out guidance on the procedures, timescales and approach that we will typically apply.
- 1.21 Ofcom must set requirements on the BBC to ensure that:
- 1.21.1 its commercial activities do not distort the market or create an unfair competitive advantage as a result of their relationship with the BBC Public Service; and
  - 1.21.2 its trading activities do not harm fair and effective competition in the UK.
- 1.22 This document is an amendment to the document published on 29 March 2017 entitled "The BBC's commercial activities: requirements and guidance".<sup>16</sup> The March 2017 document covered the BBC's commercial activities only. Now that we have considered appropriate requirements for both commercial and trading activities, we have decided to include them in one document covering the following areas:
- 1.22.1 Separation between the BBC Public Service and its commercial subsidiaries;
  - 1.22.2 How the BBC Public Service trades (supply of goods and services and pricing) with its commercial subsidiaries;
  - 1.22.3 How the BBC Public Service trades (supply of goods and services and pricing) with third parties and the general public; and
  - 1.22.4 The BBC's commercial activities undertaken by the commercial subsidiaries.
- 1.23 In combining the requirements, we have made no changes to our requirements and guidance in relation to commercial activities.
- 1.24 In addition, this document includes the procedures we will follow when reviewing any material changes to the commercial activities carried out by the commercial subsidiaries proposed by the BBC, including commencing a new commercial activity, and making a determination under our trading and separation requirements as to whether the change in activity may proceed.
- 1.25 The remainder of this document is organised as follows:
- Section 2 sets out the legal framework underpinning our role.
  - Section 3 provides an overview of the potential competition concerns associated with the relationship between the BBC's commercial activities carried out by the commercial subsidiaries and the BBC Public Service, and those associated with the trading activities. Section 3 goes on to set out the requirements we are placing on the BBC's commercial activities and trading activities.

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<sup>16</sup> *The BBC's commercial activities: requirements and guidance* is available at: [https://www.ofcom.org.uk/\\_data/assets/pdf\\_file/0018/104760/bbc-commercial290317.pdf](https://www.ofcom.org.uk/_data/assets/pdf_file/0018/104760/bbc-commercial290317.pdf)

- Section 4 sets out the procedures we will adopt to assess proposals for changes to the commercial activities that have been proposed by the BBC.
- 1.26 The procedures and guidance in this document apply to the commercial activities undertaken by the commercial subsidiaries and trading activities and take effect from 26<sup>th</sup> July 2017.<sup>17</sup> They do not cover all categories of activity which the BBC may carry out.<sup>18</sup>
- 1.27 The requirements and procedures we impose on the BBC in this document are based on the requirements previously put in place by the Trust. We are currently undertaking further work to develop our understanding of the processes and practices around the operation of the BBC's commercial subsidiaries and their relationships with the Public Service. For example, we will look in detail at the BBC's transfer pricing arrangements and the specific nature of the range of different commercial activities that sit within the BBC's commercial subsidiaries, including the BBC's identification of individual lines of business for the purpose of setting a commercial rate of return. We will also undertake further work to understand in more detail the full scope and scale of trading activities, whether they relate to the BBC Public Service trading with the commercial subsidiaries, third parties or the general public.
- 1.28 Following this further work, we will consider whether changes are required to the Operating Framework which may include additional requirements placed on the BBC. In addition, these requirements and procedures will be kept under review and amended as appropriate in the light of any change to our powers and responsibilities. We will provide an explanation where we depart from the approach set out in the procedures and guidance.

## Complaints

- 1.29 We have published procedures which set out how we will deal with complaints in relation to the BBC's competition requirements, including the requirements in this document.<sup>19</sup> We have discretion about when we open an investigation, and these procedures set out the matters which we will take into account when considering whether to investigate a complaint. When investigating complaints, we may make directions to the BBC as appropriate.
- 1.30 In addition in relation to commercial activities, when deciding whether to open an investigation concerning these activities, we will consider whether there is evidence

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<sup>17</sup> The requirements and guidance contained in a document entitled "*The BBC's commercial activities: requirements and guidance*" issued on 29 March 2017 will continue to apply to commercial activities carried out from 3 April 2017 until 26 July 2017. These requirements and guidance are available at: [https://www.ofcom.org.uk/\\_data/assets/pdf\\_file/0018/104760/bbc-commercial290317.pdf](https://www.ofcom.org.uk/_data/assets/pdf_file/0018/104760/bbc-commercial290317.pdf)

<sup>18</sup> Specifically, it does not cover: the UK Public Services, non-Service activities, provision of the World Service and a list of so-called "specified activities". These categories are further defined in the Charter and Agreement. In summary, the World Service is a non-commercial service primarily targeted outside the UK; somewhat different considerations apply to UK Public Services, and non-service activities; specified activities are matters required by the Government including support for digital television and radio coverage; Welsh, Gaelic, Irish and Ulster-Scots languages; spectrum efficiency; broadband rollout; and media monitoring. Where relevant, these activities are discussed in our *Introduction to Ofcom's Operating Framework for the BBC* – available at: [https://www.ofcom.org.uk/\\_data/assets/pdf\\_file/0030/99408/bbc-framework.pdf](https://www.ofcom.org.uk/_data/assets/pdf_file/0030/99408/bbc-framework.pdf).

<sup>19</sup> See our document, *Procedures for enforcement of BBC competition requirements*, 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)

that the BBC's arrangements are outside the market norms for the relevant line of business and if the BBC's commercial activities are likely to distort competition in the UK. We may consider the impact of the BBC's commercial activities outside the UK, where it is necessary to do so to protect UK competition. This may be the case where a company's UK and international operations are linked, so unfair competition from the BBC's subsidiaries in international markets could affect these third parties' UK activities. We would therefore expect complainants to clearly demonstrate how the BBC's arrangements are outside of market norms and in particular how they are likely to impact UK competition.

## Section 2

# Legal Framework

- 2.1 Ofcom sets out these requirements and procedures based on the legal framework contained within the Communications Act 2003 (“the **Act**”), the Charter and the Agreement. This section summarises that framework.

### **The Communications Act**

- 2.2 Ofcom is a statutory corporation created by the Office of Communications Act 2002. Our power to regulate the BBC is derived from the Act. Our general duties under section 3 of the Act therefore apply to the exercise of our functions in relation to the BBC.
- 2.3 Section 198 of the Act sets out that it shall be a function of Ofcom, to the extent that provision for them to do so is contained in the Charter and Agreement to regulate the BBC. The Act also sets out that for the purposes of carrying out regulation of the BBC, Ofcom will have such powers and duties as may be conferred on them by or under the Charter and Agreement.

### **Royal Charter for the BBC**

- 2.4 Article 46 of the Charter (Principal functions of Ofcom) requires Ofcom to prepare and publish an Operating Framework. The Operating Framework must contain the provisions and requirements Ofcom consider appropriate to secure the effective regulation of the BBC's commercial activities and trading activities among other things.
- 2.5 In relation to commercial activities, Ofcom must set requirements to ensure that the commercial activities do not, as a result of their relationship with the UK Public Services, trading activities or non-service activities, distort the market or gain an unfair competitive advantage.
- 2.6 Article 46 also sets out that in considering whether the commercial activities gain an unfair competitive advantage, Ofcom may consider in particular whether the commercial services are, or will be, undertaken in line with normal market principles, including making a commercial rate of return.
- 2.7 In relation to trading activities, Article 46(5) of the Charter requires Ofcom to set requirements, in the Operating Framework, to protect fair and effective competition in the United Kingdom in relation to (i) the effect on fair and effective competition of trading activities; and (ii) agreements with, and conduct affecting, third parties in relation to trading activities.

### **Agreement between the Secretary of State and the BBC**

- 2.8 Clauses 23 to 27 of the Agreement set out that the BBC may only make a material change to the commercial activities once Ofcom has determined that the BBC may carry out the change. Where the BBC publishes a proposed change to the commercial activities, Ofcom must first carry out an assessment of this change to determine whether it is material. If we conclude the change is material, Ofcom must then assess if the change is likely to distort the market or create an unfair competitive

advantage as a result of the relationship between the BBC Public Service and the commercial activity.

- 2.9 Clause 28 of the Agreement provides that Ofcom must set out trading and separation requirements on the BBC to ensure that commercial activities do not distort the market or gain an unfair competitive advantage as a result of their relationship with the BBC Public Service, and that these may include requirements to ensure appropriate transparency.
- 2.10 Clause 31 of the Agreement, sets out that the BBC is permitted to carry out trading activities.
- 2.11 "Trading activities" are activities which are commercial in nature but are not to be treated as commercial activities. We outline what these encompass at Annex 1.
- 2.12 The BBC must comply with the requirements in the Operating Framework to protect fair and effective competition in carrying out trading activities.<sup>20</sup>
- 2.13 Clause 32 of the Agreement states that the Operating Framework must set out how we will regulate the BBC's trading activities and the procedures to be followed (including such requirements we consider appropriate to protect fair and effective competition).

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<sup>20</sup> Clause 31(3) of the Agreement.

## Section 3

# Trading and separation requirements

- 3.1 This Section sets out the requirements placed on the BBC to address potential competition concerns arising from the relationship between the BBC Public Service and the commercial activities carried out by the commercial subsidiaries. The objective of these requirements is to ensure that this relationship between the BBC Public Service and the commercial subsidiaries does not distort the market or lead to an unfair competitive advantage. These requirements are also designed to protect fair and effective competition in relation to trading activities. In addition, we provide guidance on interpreting these requirements.
- 3.2 Competition typically produces benefits for society. Where a supplier offers a more attractive service or a better price than its rivals, it is likely to win customers and can attract new customers to the market. This in turn creates an incentive for all firms to innovate and invest in producing better services and to keep prices in line with their costs.
- 3.3 We set out at paragraph 2.2, that the BBC may have an impact on competition in the wider media market. It may have a positive effect by increasing choice or encouraging sector wide innovation, for example. But in fulfilling its objectives, the BBC may also harm the ability of others to compete effectively.
- 3.4 The unique position of the BBC as a publicly funded broadcaster enables it to create and acquire assets which can form important inputs into other services. The way that the BBC makes these assets available to the wider market has the potential to have an impact on competition. There is a concern that the BBC Public Service may use licence fee funded assets in a way which might harm fair and effective competition. These potential competition concerns are described in more detail below.
- 3.5 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.

## Potential competition concerns: Commercial activities

- 3.6 The BBC must not directly undertake any commercial activities. However, the Charter and Agreement allow it to engage in commercial activities through commercial subsidiaries. These commercial activities have the aim of generating a profit to supplement the licence fee.<sup>21</sup> To achieve this, the activities of the subsidiaries include the commercial exploitation of licence fee funded content and infrastructure.
- 3.7 Competition concerns may arise if third parties are less able to compete effectively because the relationship between the BBC Public Service and its commercial subsidiaries gives the subsidiaries an unfair competitive advantage.
- 3.8 This could occur, for example, if the subsidiaries paid less than the market rate for access to BBC Public Service assets or enjoyed preferential access to those assets. Another concern might be that the subsidiaries could distort markets by offering

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<sup>21</sup> The BBC annual report 2015/16 notes that income from commercial subsidiaries supplements the licence fee through commercial exploitation of licence fee funded content and infrastructure. See <http://downloads.bbc.co.uk/aboutthebbc/insidethebbc/reports/pdf/BBC-FS-2016.pdf> page 7.

products at below cost, sustaining ongoing losses that would not be sustainable for commercial competitors.

- 3.9 In both of these cases, if the BBC commercial subsidiaries receive an unfair competitive advantage, suppliers who compete with them may be less able to attract customers, and may be unable to expand or may be forced to exit the market entirely. This may lead to less innovation and investment, and ultimately worse outcomes for UK consumers in terms of their access to quality services.
- 3.10 To guard against these potential concerns, we set out below our requirements and provide guidance on the measures we consider the BBC should adopt. In Section 4 we set out the requirements and procedures the BBC must follow in order to make a material change to its commercial activities.

### Potential competition concerns: Trading activities

- 3.11 The BBC may generate revenue from trading activities, in order to supplement the licence fee, by selling licence fee funded assets to BBC commercial subsidiaries and the wider market.
- 3.12 Concerns with respect to trading between the BBC Public Service and its commercial subsidiaries are set out above. Concerns may also arise where the BBC Public Service is offering goods and services to the wider market.
- 3.13 Competition concerns will vary depending on the nature and scope of the trading activity in question. However, they are likely to stem from one of the following concerns:
- **Discriminatory pricing/access:** when the BBC supplies products or services to others, it may do so in an unduly discriminatory manner. This could include charging different prices to different third parties for the same service, granting preferential access or refusing to supply to certain third parties. Trading in this way may put some parties at a competitive disadvantage.
  - **Pricing below market norms:** there is a risk that the BBC Public Service offers goods and services at below market price, due to advantages that it may enjoy as a large publicly funded body, which could make it difficult for suppliers of similar services to compete.
- 3.14 The risk of adverse effects from this type of behaviour will depend on the nature of the activity in question.

### Ofcom's duties

- 3.15 Under the Agreement, as set out in paragraph 2.15, Ofcom must set 'trading and separation rules' to ensure appropriate separation between the BBC Public Service and the commercial subsidiaries, which may include requirements to ensure that:
- 3.15.1 relationships between the BBC Public Service and the commercial subsidiaries operate at arms-length;
- 3.15.2 commercial activities are carried out in accordance with normal market principles, including making a commercial rate of return; and

- 3.15.3 the relationship between the BBC Public Service and the commercial subsidiaries is appropriately transparent, including providing Ofcom with financial reports and the publication of information.<sup>22</sup>
- 3.16 Under the Agreement, Ofcom must also set out how it will regulate the trading activities and the procedures to be followed (including such requirements as Ofcom considers appropriate to protect fair and effective competition).<sup>23</sup>
- 3.17 In carrying out our role we will have regard to our general duties under the Act and in particular to the requirement under Article 45(2) of the Charter to have regard to the desirability of protecting fair and effective competition in the United Kingdom. Our focus will therefore be on potential distortions which may affect competition in the United Kingdom.

## Ofcom's requirements

- 3.18 The remainder of this document sets out our requirements applying to commercial activities undertaken by the commercial subsidiaries and trading activities. We set out our requirements under the following headings:
  - 3.18.1 Separate subsidiary;
  - 3.18.2 Operational separation requirements;
  - 3.18.3 Supply and pricing of goods and services;
  - 3.18.4 Commercial rate of return; and
  - 3.18.5 Monitoring, reporting and transparency.
- 3.19 In March 2017 we imposed requirements which govern the trading relationship between the BBC Public Service and its commercial subsidiaries. These requirements are sufficient to address our competition concerns in respect of trading of the BBC Public Service and its commercial subsidiaries as they cover:
  - 3.19.1 operational separation between the BBC Public Service and its commercial subsidiaries;
  - 3.19.2 supply of goods and services and transfer pricing between the two; and
  - 3.19.3 transparency and monitoring requirements.

All sections of this document include requirements relating to the BBC's relationship with its commercial subsidiaries.
- 3.20 In addition, following our trading activities consultation we decided to impose in July 2017 requirements governing the relationship between the BBC Public Service and the wider market. These requirements address our competition concerns in respect of the BBC Public Service trading with third parties and the general public. These requirements only appear under the headings "Supply and pricing of goods and services" and "Monitoring, reporting and transparency".

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<sup>22</sup> Agreement, Clause 28.

<sup>23</sup> Agreement, Clause 32.

- 3.21 Throughout this section we set out our requirements at the start of each sub-section, and this is followed by any additional guidance on the requirements.

## 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>24</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>24</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."

## Operational separation requirements

### The BBC must:

- Ensure that 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 Mission and Public Purposes or for the fulfilment of any existing commercial relationship.
- 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 is only used for the specific purpose for which it was obtained.
- Ensure that BBC commercial subsidiaries are run by boards and executive committees of Directors which are distinct and separate from the BBC Board and its executive committees. They should also consist of an appropriate number of directors with an emphasis on those who are separate from the BBC Board and its executive committees.
- Put in place appropriate measures to ensure that where a Director serves on the Board of both the BBC Public Service and a commercial subsidiary, any potential conflicts of interest are identified, recorded and addressed.

### Exchange of information

- 3.25 The relationship between the BBC Public Service and the commercial subsidiaries may lead to concerns that the subsidiaries could be privy to information which gives them an unfair competitive advantage. 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.
- 3.26 Equally, some exchange of information will be necessary, for example in the course of fulfilling a commercial agreement.
- 3.27 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.
- 3.28 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.

## Governance arrangements

- 3.29 In order to ensure that the 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 appropriate number of directors with an emphasis on those who are separate from the BBC Board and its executive committees.<sup>25</sup>
- 3.30 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.

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<sup>25</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.

## Supply and pricing of goods and services

### The BBC must:

- Where the BBC Public Service provides goods and services to commercial subsidiaries, ensure that arrangements are made on arm's length commercial terms.
- Where the BBC Public Service supplies goods and services to the wider market:
  - make these available to third parties on equivalent terms and prices to those offered to its commercial subsidiaries.
  - not discriminate unduly against or between third parties.
- Subject to the exception below, set pricing and terms for goods and services supplied by the BBC Public Service, whether sold to the BBC's commercial subsidiaries or to third parties, on the basis of the following principles:
  - Set market prices and terms for goods and services, where appropriate using an open market process (e.g. competitive tendering).
  - 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.
  - Where a cost-based approach to transfer pricing is used, ensure the price covers:
    - 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.
- 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 incremental cost under any circumstances.
- Ensure that 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 Brand.
- These requirements 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"*).

## Supply of goods and services

- 3.31 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.
- 3.32 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.
- 3.33 The goods and services supplied to the commercial subsidiaries and third parties can be broadly categorised as, but not limited to, the following<sup>26</sup>:
- intellectual property rights – for example, selling commercial rights to BBC programmes or selling licences to use BBC-owned technology;
  - facilities – for example, hiring out of BBC owned studios or office space;
  - staff – for example, hiring out a BBC producer to an independent production company; and
  - business support – for example, provision of finance systems and information technology services for a BBC commercial subsidiary.
- 3.34 The BBC Public Service may supply goods and services solely to the BBC commercial subsidiaries only if there is a clear reason for exclusivity or where the goods and services are being shared for reasons of operational efficiency (such as business support 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.
- 3.35 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>27</sup> and comply with the transfer pricing requirements as set out below.
- 3.36 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.
- 3.37 To address the concerns, we have around discriminatory access and pricing, where the BBC Public Service supplies goods and services to 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

<sup>26</sup> See also the specified list of trading activities, as set out in Annex 1.

<sup>27</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).

offering different prices to different parties or refusing to supply goods 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

- 3.38 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).
- 3.39 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.
- 3.40 It is also important that the BBC Public Service should not generally offer goods and services to the wider market at below market norms.
- 3.41 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.
- 3.42 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.
- 3.43 Where possible, evidence should be gathered from publicly available sources (e.g. published rate-cards<sup>28</sup>). It may also be appropriate to use 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. 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

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<sup>28</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 services. That is, the rate-card may only serve as a starting point for commercial negotiations over price.

- 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>29</sup>
- 3.44 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.
- 3.45 The BBC must not set prices below the incremental costs of providing a good or service.
- 3.46 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.
- 3.47 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 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.

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

- 3.48 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.

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<sup>29</sup> These requirements are informed by the BBC’s current Fair Trading Guidelines as of 2016, but are subject to further review by Ofcom.

## Commercial rate of return

### The BBC must:

- Earn a commercial rate of return on its commercial activities.
- Assess what an appropriate commercial rate of return is for each 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.
- Inform Ofcom where a line of business is not making a commercial rate of return.
- 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.
- 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.

3.49 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>30</sup>

3.50 We are imposing a requirement that the BBC commercial activities earn a commercial rate of return. We consider that this helps to:

- Ensure that BBC public funding is not used to finance loss making commercial activities; and
- Reinforce the principle that commercial activities are undertaken on an arm's length basis and in accordance with normal market principles.

3.51 At the same time, a key aspect of the return earned by a commercial activity will be the price it has paid for its inputs. We do not propose to focus on the rate of return in isolation and it will be necessary to 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 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/line of business in question.<sup>31</sup>

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<sup>30</sup> Agreement, Clause 28 (1) (a).

<sup>31</sup> For example, rates of return can be measured in terms of: return on capital employed; return on sales; return on investment etc.

- 3.52 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. However, Ofcom would not necessarily expect the BBC to carry out such an analysis at the level of individual products 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.
- 3.53 In assessing whether the rate of return of a line of business is appropriate, we would consider, amongst other things, whether a rational private investor would invest in the activity. 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.
- 3.54 In using this approach, it is important to recognise:
- A 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 (by which we mean the expected return is higher than the opportunity cost of capital) over an appropriate period of time;
  - In principle, we would expect every line of business to be profitable 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;
  - The actual (ex-post) return could be very different (higher or lower) than the estimated return at the time the investment is made; and
  - 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**

- 3.55 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.
- 3.56 What constitutes a commercial rate of return will depend on the specific market circumstances and Ofcom does not propose to specify rates of return. Instead, the BBC must monitor and research the markets in which the lines of business operate to ensure that the returns generated by its commercial activities are in line with market norms.
- 3.57 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 are only required to fit with the Mission and Public Purposes.

- 3.58 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.
- 3.59 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 activities. For instance, the BBC may set specific targets for its commercial activities which are intended to be more challenging than simply earning a commercial rate of return.

### Failure to meet a commercial rate of return

- 3.60 We recognise that there may be situations where returns fall below the commercial rate, particularly in the short term. For example, unexpected changes to market or economic conditions may cause performance to deviate from expectations.
- 3.61 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 review performance and consider 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.
- 3.62 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.
- 3.63 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.
- 3.64 Where Ofcom is concerned that a line of business is not earning a commercial rate of return, or considers that remedial steps decided on by the BBC are insufficient to rectify performance, Ofcom may launch an investigation. If, in those circumstances, Ofcom finds that the BBC has failed to comply with the 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 the BBC Public Service, Ofcom may direct the BBC to take action to make the line of business profitable within an appropriate time period or do anything else Ofcom considers appropriate to remedy the situation.

## Monitoring, reporting and transparency

### The BBC must:

- 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:
  - contain a clear description of the lines of business comprised within the BBC's commercial subsidiaries;
  - provide financial and performance information; and
  - 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.

3.65 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.

3.66 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.<sup>32</sup>

3.67 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.

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<sup>32</sup> Agreement, Clause 28 (1)(b).

## Reporting of transfer pricing methodologies

- 3.68 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.
- 3.69 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.
- 3.70 The BBC must also publish an explanation of the methodologies it uses for valuing the BBC brands.
- 3.71 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

- 3.72 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:
- contain a clear description of the services and activities comprised within the BBC's commercial subsidiaries;
  - provide financial and performance information; and
  - include information broken down for different types of business.
- 3.73 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.
- 3.74 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.
- 3.75 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**

- 3.76 The BBC must maintain records of its trading activities with third parties and the general public.
- 3.77 The BBC maintaining records of its trading activities will allow Ofcom to investigate complaints or carry out own-initiative investigations as required.
- 3.78 We expect to engage with the BBC periodically to ensure that its records are sufficient for our purposes.

### **Other information**

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

## Section 4

# Material changes to commercial activities

## Overview

- 4.1 From time to time, the BBC may want to change the way its commercial subsidiaries operate or undertake new activities. For example, the BBC may want to launch a new commercial activity in response to market developments.
- 4.2 This Section sets out the procedures the BBC must follow to make a material change to its commercial activities. It also sets out the procedures we will follow to determine whether the change can go ahead.

## BBC processes

- 4.3 The Agreement requires the BBC to publish a policy setting out how it will consider material changes to commercial activities, including whether or not a change is potentially material, and how it will consult with interested parties where appropriate. The policy must set out the assessment the BBC will carry out and the processes it will follow to consider whether the commercial criteria have been met. Such assessments and procedures must be proportionate to the nature of the change.<sup>33</sup>
- 4.4 The Agreement defines a material change 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 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.”<sup>34</sup>
- 4.5 The Agreement also sets out that the BBC must carry out a commercial test on any proposed material change.<sup>35</sup> The commercial test is the BBC's method for satisfying itself that the proposed change meets the commercial criteria.<sup>36</sup> It is the BBC's responsibility to determine that the commercial test is satisfied.
- 4.6 In order to satisfy the criteria that the commercial activities must not distort the market or create an unfair competitive advantage, we expect the BBC to consider

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<sup>33</sup> Agreement, Clause 23 (11).

<sup>34</sup> Agreement, Clause 23 (14).

<sup>35</sup> Agreement, Clause 24.

<sup>36</sup> The commercial criteria are set out in Clause 23 (5) of the Agreement which sets out that “In carrying out the commercial activities, the BBC must be satisfied that all of the following criteria are met- (a) the activities must fit with the Mission and the Public Purposes; (b) the activities must exhibit commercial efficiency; and (c) the activities must not jeopardise the good reputation of the BBC or the value of the BBC brand; and (d) the activities must not, 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.”

whether the commercial activity resulting from the material change complies with the trading and separation rules. In particular, as set out in Section 3, the commercial activity must be clearly separated from the BBC Public Service, transactions must be undertaken at arm's length under commercial terms, and there must be appropriate transfer pricing arrangements in place for the supply of goods and services to the commercial activity.

- 4.7 When the BBC is satisfied that the commercial test is met, the Agreement requires it to publish the proposed change and send a copy to us.<sup>37</sup>
- 4.8 The BBC must submit to us the same version of the proposal it submitted to the BBC Board including details of the commercial test carried out.<sup>38</sup> We should be provided with a full confidential version of the proposal, including all supporting documents. The BBC must also provide us with a non-confidential version suitable for publication. Any redactions to the non-confidential published version should be properly justified to enable full understanding and comment by third parties.
- 4.9 In order to satisfy our requirement that commercial activities deliver commercial rates of return, the BBC must include in the full version of the proposal a thoroughly researched, well-evidenced and robust business plan for each proposed material change to demonstrate that the service is expected to earn an appropriate commercial rate of return over a reasonable period of time (e.g. within the time horizon of the business plan). The BBC must also assess the appropriate rate of return for the activity, taking into account the risk associated with the project. We would not normally expect the business plan to be published as part of the non-confidential version.
- 4.10 We expect the BBC to send its proposal, supporting evidence and non-confidential proposal to us before publication. We should publish the non-confidential version of the proposal at the same time as the BBC.
- 4.11 If we consider that a change to the commercial activities is a material change and the BBC has failed to publish the proposed change, the Agreement provides that we may direct the BBC:
- to carry out a commercial test and, if the test is satisfied, publish the proposed change (while this is happening we expect the BBC to stop implementing the change); or
  - to stop carrying out the change in accordance with such directions as Ofcom consider appropriate.<sup>39</sup>
- 4.12 In order to reduce the chances of the BBC failing to publish a material change, we expect the BBC to keep us apprised of pipeline developments that may lead to material changes.

## Ofcom processes

- 4.13 Our assessment process comprises two stages:

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<sup>37</sup> Agreement, Clause 24 (2).

<sup>38</sup> Where the BBC has amended its proposal following third party comments during the commercial test, the version submitted to Ofcom should fully reflect any changes.

<sup>39</sup> Agreement, Clause 25 (6).

- Stage 1: Initial assessment - to determine first whether the BBC has provided sufficient information to undertake the initial assessment on whether the proposed change is material, and, if this is the case, to undertake the assessment of materiality.
- Stage 2: Trading and separation assessment – carried out on proposed changes that are material.

4.14 We set out the key stages and indicative timeframes for each stage in a flowchart at the end of this section.

### **Stage 1: Initial assessment**

- 4.15 Under the Agreement, where the BBC has published a proposed change, we must assess whether the change is a material change.<sup>40</sup>
- 4.16 We would normally conduct this initial assessment within six weeks. This is in line with the requirement in the Agreement that allows the BBC to carry out a proposed change if we have not notified the BBC as to whether we consider the proposed change to be material within this time period.<sup>41</sup>

### Sufficiency of information to make initial assessment

- 4.17 On receipt of a copy of the BBC's proposal, we will first determine if sufficient detail has been provided to enable us to conduct the initial assessment of the proposal. Any proposal needs to be capable of being fully understood by Ofcom and third parties. In addition, its scale (e.g. investment required) and timescales for implementation must be clear.
- 4.18 Where we do not consider the information provided by the BBC enables an initial assessment, we may request such additional information as we consider necessary.<sup>42</sup> This may take the form of a request for specific information or clarifications. In addition, in cases where the BBC appears to us to have published prematurely and / or further substantive work is required, we may direct the BBC to withdraw its publication and to republish and resubmit it only when that work has been completed.
- 4.19 Under the Agreement, we must make any request to the BBC for further information "as soon as possible".<sup>43</sup> Our aim is to do so within two weeks of the publication being received from the BBC. However, there may be circumstances where it would be appropriate to make such a request after that date, for example where a lack of information only becomes apparent due to issues raised with us by a third party.
- 4.20 Where we request further information, we may restart the six-week period in which we have to complete our initial assessment. Alternatively, we may put the assessment on hold and re-start the clock once the information has been received. This is because we would not consider an incomplete publication to satisfy the BBC's obligation to publish material changes.

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<sup>40</sup> Agreement, Clause 25 (1).

<sup>41</sup> Agreement, Clause 25 (4).

<sup>42</sup> Agreement, Clause 25 (5).

<sup>43</sup> Agreement, Clause 25 (5).

- 4.21 At this stage, we would focus on seeking sufficient information to assess materiality and the form of any substantive assessment. It may, of course, be the case that we require further information in the course of any further substantive assessment.

### Third party comments

- 4.22 We will invite third parties to comment on the BBC's proposed change within the initial assessment period. Generally, we will announce the start of a two-week consultation period at the time of publication of the BBC's non-confidential proposal.
- 4.23 This timescale reflects the fact that the Agreement envisages Ofcom completing our initial assessment within six weeks. It also reflects the fact that we will not, at this stage, be carrying out a full, substantive assessment of a proposed change. As the Agreement requires the BBC to have already consulted with interested parties as part of formulating its proposals,<sup>44</sup> we would expect third parties to have well developed comments by the time we and the BBC publish the final proposals.
- 4.24 In order to assist third parties in inputting to our initial assessment, we would anticipate responses to cover one or more of the following areas:
- specific areas of concern with the BBC's proposal;
  - whether the BBC has allowed third parties to input meaningfully (e.g. consulting sufficiently); and
  - whether the BBC has made errors of fact or assessment in the commercial test which call into question its conclusions.
- 4.25 Although we will not be carrying out any substantive assessment at this stage, we would welcome any evidence that stakeholders are able to provide, such as market research or assessments of competitive impact.

### Assessment of materiality

- 4.26 The Agreement sets out that Ofcom must assess whether or not the change is material.<sup>45</sup> The Agreement states that a material change to a commercial activity for the purpose of the BBC's commercial test could mean either:
- "The carrying out of a new type of commercial activity (for example, an activity previously carried out as a UK Public Service, non-service or trading activity); or
  - A significant change to the BBC's commercial arm,
- where there is a significant risk that the change may, as a result of the relationship of the activity with the Public Service, trading activities or non-service activities, distort the market or create an unfair competitive advantage."<sup>46</sup>
- 4.27 Where we consider that the change to the commercial activities does not have a significant risk of distorting the market or creating an unfair competitive advantage

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<sup>44</sup> Agreement, Clause 23 (11).

<sup>45</sup> Agreement, Clause 25 (1).

<sup>46</sup> Agreement, Clause 23 (14).

because of the relationship with the BBC Public Service, we will not consider the change to be material.

4.28 Our assessment of the materiality will depend on the proposal and the context. A non-exhaustive list of factors we may take into account include:

- an indication that the proposal would create a new relationship or change an existing relationship between a commercial activity and the BBC Public Service that could distort the market or create an unfair competitive advantage;
- whether competition may be adversely impacted rapidly or irreversibly, for example in a small or new market; and
- whether there are competitors (or an individual competitor) that are likely to be significantly affected by the change.

### Outcome of Stage 1

4.29 There are two possible outcomes for stage 1:

- Outcome 1: If we notify the BBC that the proposed change is not material,<sup>47</sup> or we have not notified the BBC as to whether or not we consider the change is material and six weeks has elapsed since the publication of the proposed change, the BBC may implement the proposal.<sup>48</sup>
- Outcome 2: Where we consider the proposed change is material we will proceed to a trading and separation assessment (stage 2). We will publish our decision to proceed to stage 2.

### **Stage 2: Trading and separation assessment**

4.30 The trading and separation assessment will focus on whether the proposed change is likely to distort the market or create an unfair competitive advantage for the BBC commercial activity as a result of the relationship between the BBC Public Service and the commercial activity.<sup>49</sup>

### Procedures for stage 2

4.31 We will make a judgment as to the level of detail required for the trading and separation assessment. This will depend on the type of change that the BBC proposes to make and our assessment of the extent of any potential negative impact on competition.

4.32 Our trading and separation assessment will follow a number of steps:

- identification of the services and products that could be affected by the proposed change;
- gathering information on the likely impact of the changes. This could include (but is not limited to) requesting further information from the BBC,

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<sup>47</sup> Agreement, Clause 25 (3).

<sup>48</sup> Agreement, Clause 25 (4).

<sup>49</sup> Agreement, Clause 26 (2).

discussions/information collection from other stakeholders and/or market research;

- assessment of the impacts;
- publication of assessment (including provisional determination); and
- final conclusions and determination.

4.33 We would normally expect to consult on our provisional determination to give stakeholders an opportunity to comment.

### Our Determination

4.34 The Agreement requires Ofcom to issue a determination to indicate one of the following:

- “The BBC may carry out the proposed change to the commercial activities;
- The BBC may carry out the proposed change in accordance with such modifications to the activity, or subject to such conditions, Ofcom consider appropriate in order to comply with the trading and separation rules; or
- The BBC may not carry out the proposed change.”<sup>50</sup>

4.35 Where we conclude that a change can go ahead without further conditions, the BBC is not *required* to carry out the change, and it remains open to the BBC not to go ahead (e.g. to give priority to other projects). However, the BBC is required to notify Ofcom and other interested parties of such a decision in line with the BBC's duties as regards transparency.

4.36 If the BBC does carry out the change, this must be the same change as that published in all substantive respects. This is because our assessment will have been based on the published proposal. The BBC must also carry out the change within the timeframes indicated in its published proposal. This is because our assessment will have been carried out in the context of the market as it existed at the time, and substantial delay may alter aspects of the assessment.

4.37 Where we conclude that a change cannot proceed, the BBC may not proceed with the proposed change. The BBC may resubmit revised proposals in future but these should address the issues raised in our final conclusions.

4.38 Where we determine that the change may proceed with modifications or conditions to address concerns we have identified, we will seek to be as specific as we can as to the nature of those modifications or conditions. Where possible, we will set these out in the form of a direction or undertakings agreed with the BBC. Where appropriate, we may consult on the nature of the modifications or conditions required.

4.39 In some cases, it may be that there needs to be some further discussion with the BBC following publication of our final decision to issue a direction or accept undertakings. Such discussions would relate to clarification and practical implementation within the BBC rather than reopening the substantive issues covered

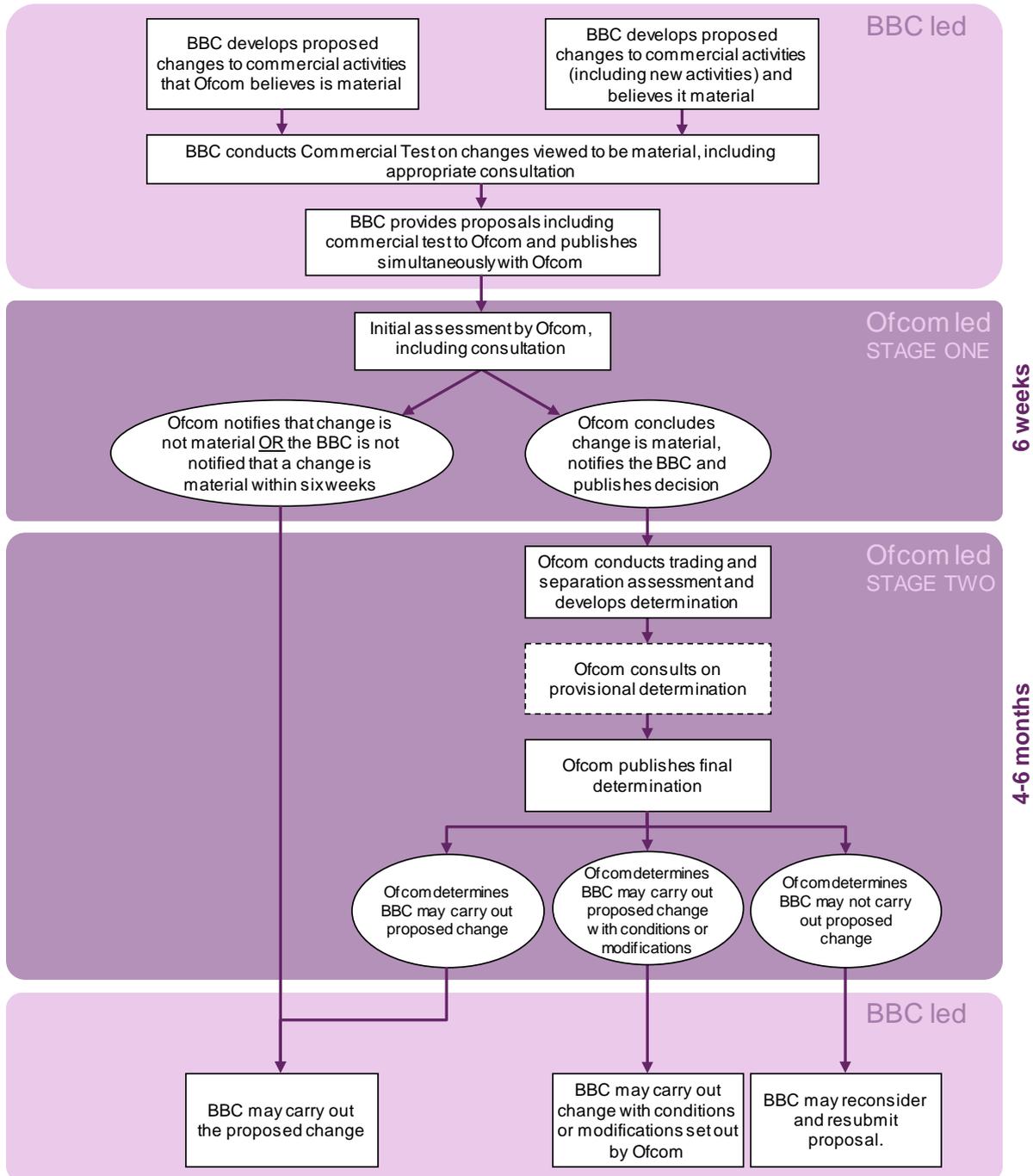
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<sup>50</sup> Agreement, Clause 27.

by the process and final conclusions. In such cases, we would publish directions or undertakings when finalised.

- 4.40 It is not possible to provide an exhaustive list of the types of modification or condition that may be appropriate as these will be highly dependent on the case. However, the purpose of such requirements would be to address any unfair advantage or market distortion as a result of the relationship between the BBC Public Service and the proposed commercial activity, or to increase transparency of the relationship between the BBC Public Service and the commercial subsidiaries. For example, we may impose rules to ensure appropriate separation or introduce reporting requirements.
- 4.41 We expect Stage 2 to take around 4-6 months, however, it may take longer where the case is complex or information gathering is protracted. Where we expect the assessment to last longer than 6 months we will inform stakeholders as soon as possible.
- 4.42 The following flowchart sets out the key stages and indicative timeframes for each stage:

## Key stages in Ofcom's process for assessing material changes to commercial activities



## Annex 1

# Trading Activities

- 4.43 Clause 31(1) of the Agreement states that the BBC may carry out trading activities in accordance with this clause.
- 4.44 Clause 31(2) states that trading activities mean the following activities which are commercial in nature but are not to be treated as commercial activities:<sup>51</sup>
- a) the selling of assets or of excess capacity in the BBC's resources held for use by the UK Public Services (including any capacity on a television multiplex service that is under the BBC's control) **(e.g. studio space)**
  - b) the provision of facilities and services which are ancillary to the provision of the UK Public Services and in respect of which any charge is imposed primarily for recovering the costs or expenses of the provision, even if other factors (for example, rounding the charge for convenience) make a profit likely; **(e.g. tickets to Public Service events)**
  - c) licensing or otherwise disposing of rights in anything created for the purposes of the UK Public Services or the World Service<sup>52</sup>; **(e.g. licensing of rights to publish the DVD of a BBC-produced programme)**
  - d) sub-licensing or otherwise disposing of rights which are not required for the promotion of the Public Purposes and which are acquired incidentally by the BBC as part of a larger package of rights which, as a whole, was acquired only because the package included rights which were required for the promotion of the Public Purposes; **(e.g. sub-licensing of sports rights)**
  - e) trading or other activity between the BBC and the BBC's commercial arm, or between different parts of the BBC's organisation; **(e.g. provision of shared services/group functions such as IT, finance or HR)**
  - f) securing up-front investment from third parties in BBC content **(e.g. provision of co-production funds in exchange for secondary distribution rights).**

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<sup>51</sup> Examples given in bold are not exhaustive, are added by Ofcom and are not part of the text of the Agreement.

<sup>52</sup> The World Service is a non-commercial service primarily targeted at audiences outside the UK. Matters relating to the World Service are not included as part of Ofcom's remit.