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## **The BBC's commercial and trading activities: requirements and guidance**

A consultation on proposed modifications to Ofcom's requirements and guidance

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# About this document

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The BBC's role is to act in the public interest and serve all audiences with content which informs, educates and entertains.

The BBC as a corporation is not allowed to undertake any commercial activities. The BBC may however carry out commercial activities through subsidiary companies. 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.<sup>1</sup>

In carrying out their activities, the commercial subsidiaries have access to certain services, information and infrastructure from within the licence fee funded part of the BBC. Therefore, there are flows of funds and assets between the licence fee funded activities and the commercial activities. Because of these relationships, there is a risk that without appropriate safeguards the BBC's public funding could be used to subsidise or benefit these subsidiaries, for example by offering services on favourable terms. This could distort competition by giving the BBC commercial subsidiaries an unfair competitive advantage compared to other companies the subsidiaries compete with.

To protect fair and effective competition we set out a number of requirements and guidance on the BBC in relation to its commercial and trading activities in 2017.<sup>2</sup> We noted at the time that we were 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. This document sets out proposed modifications to our requirements and guidance on the BBC's commercial and trading activities as a result of this work. We will consider stakeholder responses to our proposals and expect to publish our decisions by the end of 2018.

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<sup>1</sup> 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.

<sup>2</sup> The BBC's commercial and trading activities: requirements and guidance, 26 July 2017 is available at: [https://www.ofcom.org.uk/data/assets/pdf\\_file/0025/99412/bbc-commercial.pdf](https://www.ofcom.org.uk/data/assets/pdf_file/0025/99412/bbc-commercial.pdf).

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# 1. Introduction and summary

- 1.1 The BBC's role is to act in the public interest and serve all audiences with content which informs, educates and entertains.
- 1.2 The BBC as a corporation is not allowed to undertake any commercial activities. Under the Charter<sup>3</sup> and Agreement<sup>4</sup> the BBC may carry out commercial activities through subsidiary companies. 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.
- 1.3 In carrying out their activities, the commercial subsidiaries have access to certain services, information and infrastructure from within the licence fee funded part of the BBC. Therefore, there are flows of funds and assets between the licence fee funded activities and the commercial activities. Because of these relationships, there is a risk that, without appropriate safeguards, the BBC's public funding could be used to subsidise or benefit these subsidiaries, for example by offering services on favourable terms.
- 1.4 Competition concerns may arise, as a result, if third parties are less able to compete effectively because of the relationship between the Public Service<sup>5</sup> and the commercial subsidiaries. For example, if the subsidiaries were able to sustain ongoing losses, they could offer goods and services below market prices (and their actual costs). Alternatively, if they had access to information about the Public Service's strategy and priorities that was not available to third parties, they may be in a better competitive position than their rivals. This may distort competition by giving the commercial subsidiaries an unfair competitive advantage compared to their rivals.
- 1.5 One of Ofcom's principal functions in regulating the BBC is to set requirements in relation to the interaction between the BBC and its commercial activities. We must set the requirements we consider appropriate to ensure that commercial activities do not, as a result of their relationship with the Public Service, trading activities<sup>6</sup> or non-service activities, distort the market or create an unfair competitive advantage.

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<sup>3</sup> In 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>4</sup> The "Agreement" we refer to in this document is 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>5</sup> References to the 'Public Service' in the rest of this document should be read as references to BBC's UK Public Services, trading activities and non-service activities.

<sup>6</sup> "Trading activities" are activities which are commercial in nature but are not to be treated as commercial activities. Trading activities involve the provision of goods and services by the BBC to its commercial subsidiaries, third parties and the general public. Trading activities are set out in Clause 31(1) and 31(2) of the agreement and within Annex 1 of the 2017 Requirements defined in paragraph 1.6.

1.6 We published requirements and guidance in respect of the BBC's commercial activities in March 2017<sup>7</sup> and the BBC's commercial and trading activities in July 2017<sup>8</sup> (the "2017 Requirements"). The 2017 Requirements form part of the Operating Framework. In October 2017, we also set out deadlines regarding the BBC's publishing or providing of information to Ofcom in relation to the 2017 Requirements.<sup>9</sup> We noted at the time that we were 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 and, if required, we would consult on revised requirements. This consultation sets out our proposals for changes to the 2017 Requirements, given this additional work and our experience of how the current rules have worked in practice.

## Role of the BBC and the commercial subsidiaries

1.7 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 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 Public Service. Together, these obligations are known as the commercial criteria.<sup>10</sup>

1.8 As part of its duty to ensure that the BBC fulfils the Mission and promotes the Public Purposes, the BBC Board sets a strategy for the BBC's commercial activities.<sup>11</sup> It must also consider proposals for material changes to these activities and assess them against the commercial criteria.<sup>12</sup>

1.9 The Public Service may carry out trading activities 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.

1.10 At the time of publication, the BBC undertakes commercial activities through three commercial subsidiaries:<sup>14</sup>

- a) BBC Studios, which produces programme content for the BBC and the wider market. Studios also sells programmes and formats around the world as well as carrying out a

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<sup>7</sup> Regulating the BBC's impact on competition: statement on requirements and guidance, 29 March 2017 is available at: [https://www.ofcom.org.uk/data/assets/pdf\\_file/0037/99577/BBCCompetitionStatement.pdf](https://www.ofcom.org.uk/data/assets/pdf_file/0037/99577/BBCCompetitionStatement.pdf).

<sup>8</sup> The BBC's commercial and trading activities: Requirements and guidance, 26 July 2018 is available at: [https://www.ofcom.org.uk/data/assets/pdf\\_file/0025/99412/bbc-commercial.pdf](https://www.ofcom.org.uk/data/assets/pdf_file/0025/99412/bbc-commercial.pdf).

<sup>9</sup> BBC Commercial Activities: Statement, Deadlines for the publication and provision of information under the Monitoring, Reporting and Transparency requirements is available at: [https://www.ofcom.org.uk/data/assets/pdf\\_file/0026/107189/reporting-deadlines.pdf](https://www.ofcom.org.uk/data/assets/pdf_file/0026/107189/reporting-deadlines.pdf).

<sup>10</sup> Agreement, Clause 23 (5).

<sup>11</sup> Charter, Article 20 (3) (j).

<sup>12</sup> Charter, Article 20 (5).

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

<sup>14</sup> Where we refer to commercial subsidiaries, we mean the three 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.

number of other activities. In April 2018, Studios replaced two commercial subsidiaries: BBC Worldwide and the former BBC Studios.<sup>15</sup> As part of this merger, the BBC provided commitments<sup>16</sup> (the “Commitments”) intended to preserve transparency over the relationship between the Public Service and the new Studios;

- b) BBC Studioworks, which provides studio facilities and post-production services; and
- c) BBC Global News, which operates the BBC's commercial international news TV channels and websites.

## Our role and duties

- 1.11 Ofcom's functions in relation to the BBC's commercial activities are limited to issues concerning the separation of the Public Service and the commercial activities carried out by the commercial subsidiaries.
- 1.12 Under the Agreement, Ofcom must set the requirements it considers appropriate to ensure separation between the Public Service and the commercial subsidiaries, which may include requirements to ensure that:
- a) relationships between the Public Service and the commercial subsidiaries operate at arm's length;
  - b) commercial activities are carried out in accordance with normal market principles, including making a commercial rate of return; and
  - c) the relationship between the Public Service and the commercial subsidiaries is appropriately transparent, including providing Ofcom with financial reports and the publication of information.
- 1.13 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.
- 1.14 Accordingly, and as discussed in paragraph 1.6, we published requirements in 2017. Our objective was to ensure that the BBC's commercial activities do not, as a result of their relationship with the Public Service, distort the market or create an unfair competitive advantage. The 2017 Requirements were also designed to protect fair and effective competition in relation to trading activities.
- 1.15 In carrying out our role and making proposals set out in this consultation, we have had regard to our general duties under the Communications Act 2003 (the “Act”) and 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.<sup>17</sup> We have also carefully

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<sup>15</sup> The former BBC Studios produced programme content but was not involved in selling programmes and formats around the world.

<sup>16</sup> The merger of BBC Studios and BBC Worldwide. The BBC's Commitments are available at: [https://www.ofcom.org.uk/data/assets/pdf\\_file/0014/112334/BBC\\_commitments\\_to\\_Ofcom.pdf](https://www.ofcom.org.uk/data/assets/pdf_file/0014/112334/BBC_commitments_to_Ofcom.pdf).

<sup>17</sup> The legal framework is set out in Sections 1 and 2 of the 2017 Requirements.

considered the proportionality of our proposals in light of section 3(3) of the Act which requires us to ensure that our interventions must be targeted only at cases in which action is needed. We believe that our proposals meet all of the legal tests.

## Purpose and scope of consultation

- 1.16 The 2017 Requirements were based primarily on the requirements previously put in place by the BBC Trust. As we explained at the time, we have undertaken further work engaging with stakeholders and have developed our understanding of the processes and practices around the operation of the commercial subsidiaries and their relationships with the Public Service. We have also received information from the BBC under the 2017 Requirements and have assessed whether they are practicable and enable us to fulfil our duties.
- 1.17 In this consultation we therefore set out proposed modifications to the 2017 Requirements which we consider are appropriate pursuant to our obligations under the Charter and Agreement. In doing so, we set out the basis for the proposed modifications.

## Competition concerns

- 1.18 Before introducing the 2017 Requirements, we considered and identified risks and competition concerns that the commercial subsidiaries could, as a result of their relationship with the Public Service, distort the market or gain an unfair competitive advantage. The 2017 Requirements we have imposed on the BBC are *ex ante* rules which seek to address these risks and concerns.<sup>18</sup> In this consultation, we explain the risks and concerns we are seeking to address through our proposed modifications to the 2017 Requirements.

## Commercial activities

- 1.19 Competition concerns may arise if third parties are less able to compete effectively because the relationship between the Public Service and the commercial subsidiaries gives the subsidiaries an unfair competitive advantage.
- 1.20 This could occur, for example, if the subsidiaries had access to information about the Public Service's strategy and priorities that was not available to third parties. This may distort competition by giving the commercial subsidiaries an unfair competitive advantage compared to their rivals. Another concern might be that the subsidiaries could distort markets by offering goods and services at prices below cost, sustaining ongoing losses that would not be sustainable for commercial competitors.
- 1.21 In both of these cases, if the 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

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<sup>18</sup> Our competition concerns are set out in paragraphs 3.6-3.14 of our 2017 Requirements.

less innovation and investment, and ultimately worse outcomes for UK consumers in terms of their access to quality services.

### Trading activities

- 1.22 Concerns may also arise where the Public Service is offering goods and services to the wider market.
- 1.23 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:
- a) Discriminatory pricing/access: when the BBC supplies products or services to third parties, 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.
  - b) Pricing below market norms: there is a risk that the Public Service offers goods and services to third parties 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.
- 1.24 The risk of adverse effects from this type of behaviour will depend on the nature of the activity in question.

### Developments since the 2017 Requirements were put in place

- 1.25 As discussed in paragraph 1.10, the BBC merged two of its commercial subsidiaries creating the newly formed BBC Studios in April 2018. The BBC assessed the proposed merger and concluded that it did not constitute a material change as defined in the Agreement. We considered that there might be some potential concerns arising from bringing the BBC's two largest commercial subsidiaries together, in particular in relation to transparency. The BBC has provided the Commitments in respect of the proposed merger. Taking the characteristics of the BBC's proposed change, our requirements, and the Commitments provided by the BBC together, we did not consider it would be appropriate to conduct a formal assessment of the change under the Agreement.
- 1.26 We announced a review of BBC Studios looking at how it meets the requirements and guidance. We are planning to issue a call for inputs towards the end of 2018/19, which would inform the scope of work we will be likely to undertake in this area next year.
- 1.27 Since the 2017 Requirements have been in place, we have looked in more detail at the BBC's processes and procedures that relate to the 2017 Requirements as well as understanding stakeholder issues. In relation to the Public Service providing goods and services to the commercial subsidiaries, we have developed a better understanding of the range of pricing arrangements that are in place, and some issues arising from the practical implementation of our 2017 Requirements.

- 1.28 In relation to the monitoring, reporting and transparency requirements, since the 2017 Requirements came into effect, the BBC has published and submitted information to us. We have worked with the BBC to understand this financial information and have discussed and considered stakeholder concerns raised about the reporting requirements and the information the BBC has published. We said in our 2017 Requirements that reporting was an area that was likely to evolve over time as we develop our understanding.
- 1.29 This consultation covers aspects of the requirements under the following headings:
- a) Operational separation;
  - b) Supply and pricing of goods and services;
  - c) Commercial rate of return; and
  - d) Monitoring, reporting and transparency requirements.
- 1.30 We do not propose to make any amendments to the procedures we have in place to assess changes to the commercial activities that have been proposed by the BBC.
- 1.31 The requirements will be kept under review and amended as appropriate in 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.

## Other related work

- 1.32 There are a number of other related activities which we and other stakeholders have already undertaken or are currently undertaking.
- 1.33 Schedule 3(7) of the Agreement places requirements on the BBC to ensure that more of the programmes and materials for its UK public services are made as a result of a contestable process on a fair, reasonable, non-discriminatory and transparent basis between different types of producer. Today, we have also published a consultation setting out how we propose to fulfil our role in assessing and enforcing these requirements and whether we should introduce additional requirements in the Operating Framework to protect fair and effective competition (the "Commissioning Requirements"). We welcome stakeholder views on our proposed approach in this consultation.<sup>19</sup>
- 1.34 In March 2018, the National Audit Office published a landscape review of the BBC's commercial activities.<sup>20</sup> This report examined how the commercial activities are organised, overseen and regulated, how the activities have fared in terms of their commercial performance and contribution to the BBC's public purposes, and how the BBC is responding to the opportunities and challenges its commercial activities face. This was followed by the Public Accounts Committee report on the commercial activities in July

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<sup>19</sup> Commissioning for the BBC Public Services, 30 July 2018 is available at:

<http://teams/sites/cont/cta/condraft/BBC%20commerical%20activities%20consultation%20v2.docx>

<sup>20</sup> See, 'The BBC's Commercial Activities: A Landscape Review' NAO

<https://www.nao.org.uk/wp-content/uploads/2018/03/The-BBCs-commercial-activities-a-landscape-review.pdf>.

2018.<sup>21</sup> This report considered that the BBC is facing increasing challenges from commercial competitors and its commercial subsidiaries are working in increasingly competitive markets. It also noted that the commercial performance has been flat in recent years and the BBC faces significant risks to future performance. The report therefore considered that the licence fee payer has a fundamental interest in the value that the BBC's commercial activities deliver, for which the BBC Board is accountable.

1.35 In May 2018, the BBC announced that it was reviewing transparency in both the Public Service and the commercial parts of the BBC Group.<sup>22</sup> We understand that the review relating to the BBC's commercial subsidiaries will focus on the BBC's obligations and existing practice around disclosure and transparency.<sup>23</sup>

1.36 On 11 July 2018, the BBC published its Annual Report and Accounts for 2017/2018,<sup>24</sup> as well as its Annual Report and consolidated financial statements for its commercial holdings.<sup>25</sup> The BBC provided certain information within these publications as part of the 2017 Requirements and some information under the Commitments.

## Summary of our proposals

1.37 In this consultation, we set out our proposals for modifying the requirements and guidance. We also propose some additional requirements, particularly with respect to reporting.

### Operational separation

1.38 The existing operational separation requirements address the relationship between the Public Service and the commercial subsidiaries. They require that the governance of the commercial subsidiaries is distinct and separate from the Public Service and place restrictions on the commercial subsidiaries accessing information regarding the Public Service's strategy, priorities and activities which is not available to third parties.

1.39 We propose to broadly maintain our 2017 Requirements on operational separation, although we are proposing some clarificatory amendments. We also propose to introduce new transparency and monitoring obligations, including a requirement on the BBC to publish an Annual Statement on Operational Separation. This will give us and stakeholders confidence that an appropriate internal framework has been developed to ensure compliance with the requirements around information sharing and governance.

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<sup>21</sup> See: [https://publications.parliament.uk/pa/cm201719/cmselect/cmpublic/670/67003.htm#\\_idTextAnchor000](https://publications.parliament.uk/pa/cm201719/cmselect/cmpublic/670/67003.htm#_idTextAnchor000).

<sup>22</sup> BBC Group means the BBC and each commercial subsidiary.

<sup>23</sup> See 'Transparency Reviews Terms of Reference' The BBC

<http://www.bbc.co.uk/mediacentre/statements/transparency-review-terms-of-reference>.

<sup>24</sup> See BBC Annual Report and Accounts, 2017/18

[http://downloads.bbc.co.uk/aboutthebbc/insidethebbc/reports/pdf/bbc\\_annualreport\\_201718.pdf](http://downloads.bbc.co.uk/aboutthebbc/insidethebbc/reports/pdf/bbc_annualreport_201718.pdf).

<sup>25</sup> See Commercial Holdings Limited Accounts 2017/18

[http://downloads.bbc.co.uk/aboutthebbc/insidethebbc/reports/pdf/commercial\\_holdings\\_limited\\_accounts\\_201718.pdf](http://downloads.bbc.co.uk/aboutthebbc/insidethebbc/reports/pdf/commercial_holdings_limited_accounts_201718.pdf).

## Supply and pricing of goods and services

- 1.40 The existing requirements set out a number of obligations on the Public Service in relation to the price and non-price terms and conditions of goods and services that the Public Service buys and sells from its commercial subsidiaries as well as those it sells to third parties.
- 1.41 We are proposing some modifications to aspects of the 2017 Requirements to allow for different approaches to be taken given the nature of the goods and services provided and the related competition concerns. In general, we remain of the view that the BBC should set prices for goods and services based on the relevant market price or market benchmark, with a fall back option of prices being based on costs where there is no available, reliable, market information. However, we are proposing that the prices for the business support services that the Public Service only provides within the BBC Group, such as HR, IT, finance and legal, and would not otherwise sell externally, should be based on the long run costs of provision.

## Commercial rate of return

- 1.42 The BBC is currently required to earn a commercial rate of return on its commercial activities. We also require it to assess what an appropriate commercial rate of return is for each line of business, and to take certain steps should a line of business not make this level of return.
- 1.43 We are proposing to specify that the BBC must earn a commercial rate of return over an appropriate period of time and that, if during that time period the BBC considers that a commercial rate of return will not be generated, it must take appropriate steps to earn that commercial rate of return. We also propose to make clear that the BBC must earn a commercial rate of return on each line of business as well as at the subsidiary level.

## Monitoring, reporting and transparency

- 1.44 The existing monitoring, reporting and transparency requirements support all the other requirements. We have considered what modifications we need to make to these requirements in light of our proposed amendments to the other requirements.
- 1.45 In addition, as discussed above, having undertaken additional work in this area, we have identified some gaps in the information we require to fulfil our duties. We therefore propose a number of additional reporting requirements in order to provide us and other stakeholders with increased transparency. We also propose to reduce the frequency of the existing quarterly reporting to biannual and to make a number of amendments to some of the current reporting requirements to provide further clarity. We consider these proposals, if implemented, would enable us to monitor the relationship between the Public Service and the commercial subsidiaries and to fulfil our duties more effectively.

- 1.46 We propose that the reports for the 2018/19 financial year that the BBC is required to publish or provide to us in July 2019 must be produced in accordance with the modified requirements.

## Other proposals

- 1.47 The definition of commercial activities within the Agreement allows for the participation by the commercial subsidiaries in joint ventures or other forms of commercial partnership with entities other than the BBC or its commercial arm. It also requires the BBC to use its best endeavours to ensure that its participation in any joint venture and the activities undertaken comply with the commercial criteria. We are therefore proposing to modify the requirements and guidance to make clear where they also apply to joint ventures that the commercial subsidiaries have entered into.
- 1.48 In addition, in light of the work we have undertaken discussed above, we also consider that there is scope for the obligations and guidance forming part of the 2017 Requirements to be made clearer, more precise and less repetitive.
- 1.49 We therefore propose to define certain terms to which we refer in the requirements and remove the repetitions of the BBC's obligations which are currently included as part of our guidance. These changes should ensure that the BBC and other stakeholders better understand how the requirements and guidance apply to the BBC. We also plan to move some of the background material currently in the guidance into other sections of the document we will publish as part of our statement.<sup>26</sup>

## Impact assessment

- 1.50 The analysis presented in this consultation constitutes an impact assessment as defined in section 7 of the Act.
- 1.51 Impact assessments provide a valuable way of assessing different options for regulation and showing why the preferred option was chosen. They form part of best practice policy-making. This is reflected in section 7 of the Act, which means that generally we have to carry out impact assessments where our proposals would be likely to have a significant effect on businesses or the general public, or when there is a major change in Ofcom's activities. However, as a matter of policy Ofcom is committed to carrying out impact assessments in relation to the great majority of our policy decisions.<sup>27</sup>

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<sup>26</sup> For example, the material currently contained in paragraph 3.33 of the 2017 Requirements may be incorporated into other sections of that document. We do not set out details of the guidance we plan to move in this consultation.

<sup>27</sup> For further information about our approach to impact assessments, see the guidelines, Better policy-making: Ofcom's approach to impact assessment, which are on our website:

[http://stakeholders.ofcom.org.uk/binaries/consultations/ia\\_guidelines/summary/condoc.pdf](http://stakeholders.ofcom.org.uk/binaries/consultations/ia_guidelines/summary/condoc.pdf).

## Equality impact assessment

- 1.52 Ofcom is separately required by statute to assess the potential impact of all our functions, policies, projects and practices on race, disability and gender equality. Equality Impact Assessments (EIA) also assist us in making sure that we are meeting our principal duty of furthering the interests of citizens and consumers regardless of their background or identity.
- 1.53 It is not apparent to us that the proposals set out in this consultation are likely to have any particular impact on race, disability and gender equality. Specifically, we do not envisage the impact of any outcome to be to the detriment of any group of society. Nor do we envisage any need to carry out separate EIAs in relation to race or gender equality or equality schemes under the Northern Ireland and Disability Equality Schemes. This is because we anticipate that our regulatory intervention will not have a differential impact in relation to people of different gender or ethnicity, on consumers in Northern Ireland or on disabled consumers compared to consumers in general. Similarly, we do not consider that our proposals will have a particular impact on consumers in different parts of the UK or between consumers on low incomes.

## Structure of this consultation and next steps

- 1.54 The remainder of this document is organised as follows:
- Section 2 sets out our proposals on the operational separation requirements;
  - Section 3 sets out our proposals on the supply and pricing of goods and services;
  - Section 4 sets out our proposals on the commercial rate of return requirements;
  - Section 5 sets out our proposals on monitoring, reporting and transparency;
  - Annex 1 sets our proposed modified requirements and guidance;<sup>28</sup>
  - Annex 2, published separately, also sets out our proposed modified requirements and guidance and shows stakeholders what changes we are proposing compared with the 2017 Requirements;
  - Annexes 3-5 set out information about how to respond to this consultation; and
  - Annex 6 sets out our consultation questions.
- 1.55 We welcome any views and comments which respondents may have on the issues raised in this document. This consultation closes on 24 September 2018. We will consider stakeholder responses to our proposals and expect to publish our decisions by the end of 2018.

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<sup>28</sup> As part of Annex 1, we set out proposed templates to instruct the BBC how its reporting outputs must be prepared, as a minimum, to comply with certain of the specified reporting requirements.

- 1.56 We propose that the modified requirements will take effect from the date of publication of our final decision. The 2017 Requirements remain in force until such time. When we issue our final statement, we will also publish accompanying sections of the revised requirements and guidance such as details of the legal framework.<sup>29</sup>
- 1.57 We will continue to keep the requirements under review and amended as appropriate in light of further experience and any changes to our powers and responsibilities.

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<sup>29</sup> We plan to publish sections including: an introduction, legal framework and competition concerns related to the trading and commercial activities as well as the requirements and guidance, material changes to commercial activities section and a list of the trading activities.

## 2. Operational separation

### Introduction

- 2.1 The operational separation requirements address the relationship between the Public Service and the commercial subsidiaries. They relate to the exchange of information and governance arrangements which we discuss in turn in this section.
- 2.2 Since the 2017 Requirements were put in place, we have engaged with the BBC in order to get an understanding of the processes and procedures it has in place to ensure compliance with the operational separation requirements. We have also engaged with other stakeholders to ask for their initial view on issues in relation to operational separation.
- 2.3 As explained in Section 1, our competition concern is that third parties may be able to compete less effectively if the relationship between the Public Service and the commercial subsidiaries gives the subsidiaries an unfair competitive advantage. In the context of the operational separation requirements, we are particularly concerned that the commercial subsidiaries might have access to commercially sensitive Public Service information not available to others, which may put them at a competitive advantage.
- 2.4 In this consultation, we have considered whether, and to what extent, the requirements need to be modified, or whether further guidance is required, to clarify our expectations. We have also considered whether there is a need for greater transparency – for stakeholders and for us – regarding how the BBC is implementing its operational separation obligations.
- 2.5 In summary, we plan to broadly maintain our 2017 Requirements on operational separation, although we are proposing some clarificatory amendments. We also propose to introduce new transparency and monitoring obligations, including a new requirement on the BBC to publish an Annual Statement on Operational Separation.
- 2.6 In addition, as explained in Section 1, we have made explicit in the proposed changes to the requirements and guidance in Annex 1 how they apply to joint ventures that the commercial subsidiaries participate in.
- 2.7 In the remainder of this section, we outline the requirements and duties on the BBC, before setting out our analysis and proposals in relation to the exchange of information and governance arrangements in turn.

### Current requirements and duties on the BBC

- 2.8 The Agreement states that the BBC must not directly undertake any commercial activities, and they must instead be provided through one or more commercial subsidiaries.<sup>30</sup> The

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<sup>30</sup> The Agreement, section 23, paragraph (4) and section 28, paragraph (1) (ii), [http://downloads.bbc.co.uk/bbctrust/assets/files/pdf/about/how\\_we\\_govern/2016/agreement.pdf](http://downloads.bbc.co.uk/bbctrust/assets/files/pdf/about/how_we_govern/2016/agreement.pdf).

Operating Framework that we have put in place for the BBC includes a 'separate subsidiary' requirement which prevents the BBC from directly undertaking commercial activities and requires all commercial activities to be undertaken through commercial subsidiaries.<sup>31</sup>

- 2.9 As part of its duty to ensure that the BBC fulfils the Mission and promotes the Public Purposes, the BBC Board sets a strategy for the BBC's commercial activities.<sup>32</sup> In addition, the Agreement requires the BBC to ensure that the 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 Public Service.<sup>33</sup>
- 2.10 Our requirements on operational separation are complementary to other trading and separation requirements that relate to the financial flows between the Public Service and the commercial subsidiaries (e.g. supply and pricing of goods and services and commercial rate of return) in defining an appropriate level of separation in the relationship between the Public Service and the commercial subsidiaries.<sup>34</sup>
- 2.11 The operational separation requirements cover two areas:
- Exchange of information – restrictions on information regarding the Public Service's strategy, priorities and activities that is not available to third parties which can be accessed by the commercial subsidiaries, and mechanisms to ensure that privileged information is only used for the specific purposes for which it was obtained; and
  - Governance arrangements – requirements to ensure that governance of the commercial subsidiaries is distinct and separate from the Public Service governance, with measures in place to ensure that any potential conflicts of interest that arise from cross-directorships are identified and managed.

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<sup>31</sup> We are modifying the separate subsidiary requirement to make clear that the commercial subsidiaries should be at arm's length from the Public Service and bringing it together with the operational separation requirements. As the current guidance relating to the separate subsidiary requirement duplicates the requirement, we propose to remove the guidance. We do not consider that any additional guidance is necessary.

<sup>32</sup> Charter, Article 20 (3) (j).

<sup>33</sup> The Agreement, section 23, paragraph (5), [http://downloads.bbc.co.uk/bbctrust/assets/files/pdf/about/how\\_we\\_govern/2016/agreement.pdf](http://downloads.bbc.co.uk/bbctrust/assets/files/pdf/about/how_we_govern/2016/agreement.pdf).

<sup>34</sup> We also note that operational separation is covered in the Commitments. The BBC Board and BBC Fair Trading Committee have committed to monitor operational separation and the external annual Fair Trading Audit considers the effectiveness of the BBC's controls including operational separation. The Auditor's report is published as part of the BBC Annual report and Accounts (which was published in July 2018). The Commitments also cover information flows between the Public Service and BBC Studios as well as conflicts of interest procedures in Studios. The Commitments also required the BBC to publish a structure chart of BBC Studios.

## Our approach and proposals

### Competition concerns

- 2.12 Our primary competition concern when imposing the 2017 Requirements on operational separation (and in imposing other trading and separation requirements) was to ensure that the relationship between the Public Service and the commercial subsidiaries is at arm's length and does not distort the market or lead to unfair competitive advantage for the BBC's commercial subsidiaries. We continue to have these competition concerns.
- 2.13 The 2017 Requirements on operational separation put obligations on the BBC in relation to non-financial risks to competition – the sharing of information between the Public Service and the commercial subsidiaries and the governance arrangements for the commercial subsidiaries. We consider that the requirements are important in addressing our competition concerns arising from the exchange of information and the BBC's governance arrangements. In particular:
- the risk that Public Service information is shared with the commercial subsidiaries at governance and/or operational levels, giving them a competitive advantage that is not available to third parties; and/or
  - the risk that the influence of the Public Service shapes the governance of the commercial subsidiaries in a way which is inconsistent with an arm's length relationship. This influence could give the commercial subsidiaries an unfair competitive advantage or lead to their activities not being carried out on a commercial basis to the detriment of third parties.

### Our proposed Annual Statement on Operational Separation

- 2.14 We believe that, broadly speaking, the current operational separation requirements are fit for purpose in meeting our competition concerns. We discuss below some modifications to the current requirements and propose new guidance in relation to the information sharing requirements.
- 2.15 However, in 2017 we did not put in place any reporting or transparency requirements requiring the BBC to report on the measures, controls and processes that it has put in place to meet these requirements. We and other stakeholders have limited visibility of how the BBC is complying with the requirements.
- 2.16 We require assurance that the relationship between the BBC and its commercial subsidiaries is at arm's length and does not distort the market or create an unfair competitive advantage. It is crucial that we, and stakeholders, have confidence that the BBC has put in place the necessary measures to ensure compliance with the requirements. We therefore propose to require the BBC to produce an Annual Statement on Operational

Separation. We consider that such a statement will give us and stakeholders confidence that appropriate internal frameworks have been developed.<sup>35</sup>

- 2.17 We propose that the Annual Statement should include:
- a) an overview of the processes the BBC has adopted in identifying areas of risk for information sharing (we discuss risk based assessments in paragraph 2.33);
  - b) a description of all measures, internal controls and processes implemented to ensure compliance with the requirements. This should include any relevant internal codes or policies that the BBC may have put in place to ensure compliance (see paragraph 2.34);
  - c) an account of how the governance of the commercial subsidiaries reflects our requirements (see paragraph 2.47), including our requirement for distinct and separate governance; and the processes in place to manage conflicts of interest and information-sharing risks due to cross-directorships<sup>36</sup> (see paragraphs 2.51-2.52); and
  - d) an explanation of any issues with the effectiveness of the BBC's controls during the previous financial year and what steps the BBC has taken to improve their effectiveness.
- 2.18 We propose to require the BBC to submit this statement to Ofcom, and to publish it on its website, at the same time as the publication of the BBC Annual Report and Accounts. We propose the first statement should be submitted in July 2019. It should include a comprehensive statement on the measures, controls and processes the BBC has implemented to deal with areas of risk as at 31 March 2019.
- 2.19 Below we provide more context and reasoning on our proposal to require the BBC to publish the Annual Statement on Operational Separation and make some proposals to amend the operational separation requirements. We also set out proposals for additional transparency and reporting requirements in relation to the operational separation requirements.

## Exchange of information

- 2.20 Our 2017 Requirements restrict the circumstances in which commercially sensitive information can be shared between the Public Service and the commercial subsidiaries. These requirements are intended to address our competition concern that third parties may be less able to compete effectively if information shared between the Public Service and the commercial subsidiaries gives the subsidiaries an unfair competitive advantage. The requirements are comprehensive in scope, relating to all types of information sharing and impact on all employees and directors of both the Public Service and the commercial

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<sup>35</sup> The proposed reporting requirement is set out in D.2 in Annex 1, in which we call the Annual Statement described above the Operational Separation Statement.

<sup>36</sup> By cross-directorships, we mean where BBC Board members and/or Public Service executives also sit on the commercial subsidiary boards and/or executive committees.

subsidiaries. They are also behavioural in nature, which creates challenges in relation to internal controls and external monitoring.

- 2.21 Some stakeholders have raised concerns around information sharing between the Public Service and commercial subsidiaries, although these concerns have been general rather than specific. Given the nature of the existing requirements, it may be difficult for stakeholders to have visibility of how the BBC complies with the requirements.
- 2.22 We have engaged with the BBC to get some understanding of the internal processes and procedures in place to restrict the sharing of commercially sensitive information. The BBC stated that it takes a risk-based approach to these requirements and referenced various procedures in place to mitigate risks around information sharing, including conflict of interest procedures, separation of access to various systems, and training and guidance for some staff.<sup>37</sup> We consider that our proposal above for an Annual Statement on Operational Separation will provide more transparency and assurance regarding the processes that have been put in place.
- 2.23 We have reviewed the requirements and while we believe that on the whole they remain fit for purpose, we consider they could be more clearly focused in addressing the competition concern we have identified. We propose to address this by amending the requirements to allow information sharing in specific circumstances where there is no risk to competition and by providing high-level guidance on the relevant considerations the BBC should take into account. We continue to consider that it is appropriate to permit information sharing where it is required to ensure the activities of the commercial subsidiaries fit with the BBC's Mission and Public Purposes or for the fulfilment of a contract.

## Guidance on information sharing

- 2.24 We do not consider it feasible or desirable to provide exhaustive lists of the types of information that can or cannot be shared between the Public Service and the commercial subsidiaries. However, we think that it would be helpful to the BBC and other stakeholders if we provide guidance including some examples of types of information sharing and the relevant considerations the BBC should take into account in determining whether there is a risk of an unfair competitive advantage to its commercial subsidiaries.<sup>38</sup>
- 2.25 For example, we consider the commissioning of programming by the Public Service to be an area where information sharing could result in an unfair competitive advantage or market distortion. Independent producers are competing with BBC Studios' producers for substantial (and increasing) numbers of TV and radio programmes each year. If BBC Studios has access to commercially sensitive information regarding the commissioning strategies and needs of the Public Service well in advance of other producers, it may be in a better

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<sup>37</sup> For example, as a result of the new regulatory framework, to ensure compliance with Ofcom's requirements the BBC says it has comprehensively reviewed and relaunched its target training programme for staff likely to encounter Fair Trading issues. See BBC Annual Report and Accounts 2017/18, page 122.

<sup>38</sup> The proposed guidance is set out in A.9-12 of Annex 1.

- position to prepare and submit tailored ideas and pitches and win commissions. Examples of commercially sensitive information that could raise competition concerns include advance notice of plans to commission large amounts of programmes on a particular theme, changes to genre strategies or specific decisions in relation to recommissioning of existing programmes. If commercially sensitive information is shared in this way, it may also be a breach of the requirement that competition between BBC producers and external producers is conducted on a fair, reasonable, non-discriminatory and transparent basis.<sup>39</sup>
- 2.26 There are other areas where the sharing of information could present a risk of unfair competitive advantage or market distortion including content distribution and sales. For example, if a commercial subsidiary had knowledge of the Public Service's confidential plans to adapt its strategy for the distribution of Public Service content (e.g. children's programming), then this could give rise to an unfair competitive advantage. Other areas of potential unfair competitive advantage include audience research and performance measures. Producers and distributors within BBC Studios may be at an advantage relative to their competitors if they have access to audience research and performance measures which are not available to third parties. This may assist them in securing future commissions to produce and/or distribute content for the BBC.
- 2.27 Meanwhile, news production is an area where we are mindful of the BBC's legitimate interest in sharing information between BBC News and BBC Global News to ensure that the output of BBC World News fits with the BBC's Mission and Public Purposes (which includes the provision of impartial news and information, and reflecting the UK, its culture and values to the world).
- 2.28 In some circumstances the commercial subsidiaries will have a commercial relationship in place with the Public Service. For example, BBC Studioworks may have entered into a contract to provide studio space for live productions produced by the Public Service. In such cases, the provision in our requirements permitting the exchange of information for the fulfilment of a commercial contract could be relevant.
- 2.29 We recognise that some Public Service employees have 'group-wide' responsibilities across the BBC, which cover both the Public Service and the commercial subsidiaries. This may include shared services such as HR functions where the Public Service provides services to the commercial subsidiaries on a commercial basis. We recognise that some types of information are likely to carry lower or no risks, for example administrative information associated with shared services (e.g. payroll administration information). We do, however, expect the BBC to consider all aspects of the information it holds, the interfaces between the Public Service and commercial subsidiaries and whether any information, if shared, would carry a risk of providing unfair advantage to the commercial subsidiary.

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<sup>39</sup> We have also published a consultation regarding our proposed approach to assessing the BBC's compliance with requirements on commissioning set out in Schedule 3 of the Agreement, including the requirement to commission on a fair, reasonable, non-discriminatory and transparent basis, see:

<http://teams/sites/cont/cta/condraft/BBC%20commercial%20activities%20consultation%20v2.docx>.

- 2.30 We welcome stakeholder comments on the proposed guidance on information sharing and, in particular, what the key areas of concern are, and whether additional guidance would be useful.

## Our proposals on information sharing and reporting

- 2.31 To ensure that the regulation we put in place is targeted and proportionate, we propose to modify the information sharing restriction on the BBC, to permit information sharing in the specific circumstances where there is no risk to competition.<sup>40</sup> This recognises that there could be some categories of information that would carry no risk of competitive advantage if shared between the Public Service and commercial subsidiaries. If the BBC can show that it has reasonably determined that there is no risk to competition, then it would be permitted to share that information in those particular circumstances.
- 2.32 In addition, we are proposing to modify the information exchange requirements to make clear that the BBC must have appropriate “measures, controls and processes” so that the commercial subsidiaries do not have access to the Public Service information that is not available to third parties (apart from in the limited circumstances where information sharing is permitted).<sup>41</sup> Our analysis has highlighted the importance of having measures, controls and processes in place if the BBC is to mitigate the risk that the commercial subsidiaries have access to information that puts them at a competitive advantage. The BBC should already have put in place an appropriate internal framework to ensure compliance with the existing requirements, and we consider it proportionate and practical to reflect this in the requirements. While we are not proposing to prescribe these measures, controls and processes in detail, we provide guidance on relevant considerations below.<sup>42</sup> If we found the BBC's measures, controls and processes to be inadequate in mitigating our competition concern, the revised requirements would allow us to step in, if appropriate.
- 2.33 In order to comply with the information exchange requirements, we expect the BBC will need to carry out, and keep updated, a comprehensive risk assessment. This would allow it to identify the areas which could present a risk of an unfair competitive disadvantage or market distortion and to consider the measures, controls and processes that it should implement to ensure that information flows are controlled in these circumstances. At a minimum any such risk assessment should include:
- identification of all interfaces between the Public Service and the commercial subsidiaries where information is (or could be) shared;
  - assessing what types of commercially sensitive Public Service information, not available to others, could put the commercial subsidiaries at an unfair competitive advantage or lead to market distortion; and

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<sup>40</sup> The proposed modification is set out in requirement A.2(c) in Annex 1.

<sup>41</sup> The proposed modifications are set out in requirements A.2-3 in Annex 1.

<sup>42</sup> The proposed guidance is set out in paragraphs A.7-8 in Annex 1.

- determining if the information sharing is necessary to ensure the activities of the commercial subsidiaries fit with the BBC's Mission and Public Purposes or for the fulfilment of a commercial contract.

2.34 To comply with our proposed requirements (including in relation to the Annual Statement), the BBC will need to develop and tailor mechanisms specifically to mitigate the risks identified in the risk assessment, including developing controls to ensure that information that has been shared is only used for the specific purpose for which it was obtained. We would expect such measures, controls and processes to include:

- Training of staff and internal guidance: to ensure that the staff of the Public Service and commercial subsidiaries have a strong awareness of what information could be shared and what should not be shared. This should include training of members of boards and executive committees, as well as guidance on their roles and responsibilities.
- Location of staff: to consider what controls are appropriate to manage information flows where Public Service and commercial subsidiary staff are co-located.
- IT system controls: to ensure that there are controls in place restricting staff access to information systems which contain commercially sensitive information. Controls could include restricted access to ICT systems that contain commercially sensitive information for commercial subsidiaries staff.
- Conflicts of interest procedures: to ensure that there are procedures in place to manage conflicts of interest and risks of information sharing that may arise from cross-directorships.
- Internal compliance checks: of its risk assessment and the controls in place to manage information sharing risks.<sup>43</sup>

2.35 As part of the BBC's Commitments in relation to the BBC Studios merger, the BBC said that the external Fair Trading Audit will consider (amongst other things), the effectiveness of the controls BBC has put in place in relation to operational separation.<sup>44</sup> We expect that this audit will include a review of the measures, controls and processes the BBC has put in place to ensure that it meets its operational separation requirements and how these are working in practice.

2.36 We believe this (and other) Commitments form an important part of our regulatory framework. However, as we outlined above, to provide us, and stakeholders, with greater transparency and assurance, we propose that the BBC should publish an Annual Statement on Operational Separation. This should include an overview of its approach to risk

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<sup>43</sup> We include in the reporting requirements the proposal to include a description of these types of measures, controls and processes as part of the Annual Statement on Operational Separation. This proposed requirement is set out in paragraph D.2 in Annex 1.

<sup>44</sup> As also discussed in Section 5, the BBC's independent Fair Trading Auditors currently audit the system of internal controls established within the BBC to provide the BBC with reasonable assurance that it has complied with Ofcom's 2017 Requirements. See BBC Annual Report and Accounts 2017/18, page 122.

assessment and a description of the measures, controls and processes it has implemented to ensure compliance with our information sharing processes.

## Governance

- 2.37 Effective and independent governance arrangements for the commercial subsidiaries are an important component of ensuring that the commercial activities are undertaken at arm's length from the Public Service and on commercial terms. We have engaged with the BBC to understand developments in its governance arrangements in the context of our existing operational separation requirements. We have also considered if the requirements that relate to governance require any clarification and what transparency and reporting requirements are needed.

### BBC governance arrangements

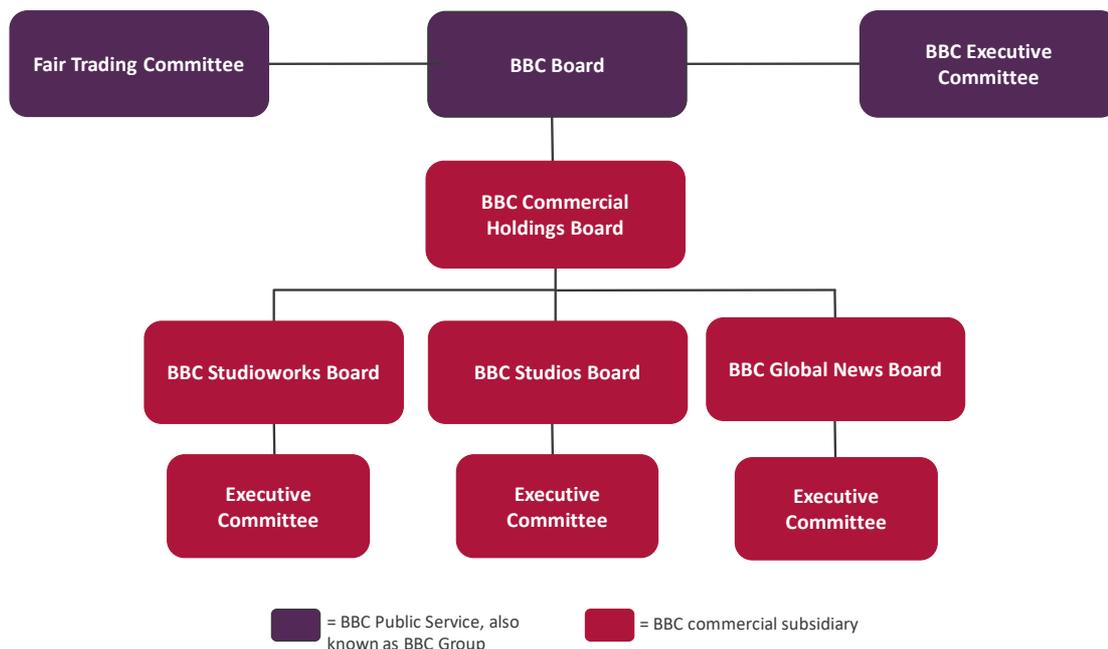
- 2.38 The BBC Board is responsible for the overall oversight of the BBC's commercial activities. The Fair Trading Committee – a BBC Board sub-committee – is responsible for overseeing the BBC's compliance with its regulatory obligations for trading and separation between the Public Service and the commercial subsidiaries. One of its core requirements is to review, approve and oversee the trading and separation arrangements for each of the BBC's commercial subsidiaries.
- 2.39 The Commercial Holdings Board is now the main governance body for the commercial subsidiaries and sits between the BBC Board and the commercial subsidiaries' boards and executives.<sup>45</sup> The Commercial Holdings Board approves the BBC Commercial Group's strategy and that of each commercial subsidiary, and is accountable to the BBC Board for compliance obligations.<sup>46</sup>

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<sup>45</sup> Each of the three main commercial subsidiaries has a board and an executive committee. The boards are legal decision-making bodies to enact decisions made at the Commercial Holdings Board. The executive committees are responsible for the day-to-day running of each commercial subsidiary.

<sup>46</sup> BBC Commercial Holdings Board Terms of Reference.

Figure 2.1: Current BBC governance arrangements



- 2.40 In October 2017, the BBC expanded the role of the Commercial Holdings Board to include oversight of the operations and performance of the main subsidiaries.<sup>47</sup> The BBC also expanded the membership to include two independent non-executive directors. The Commercial Holdings Board consists of ten directors, including four BBC Public Service/ Group executives, four executives from the commercial subsidiaries and two independent non-executive directors. The Director-General of the BBC is Chair of the Commercial Holdings Board.
- 2.41 There is limited information in the public domain regarding the governance of the commercial subsidiaries and how their boards/executive committees and the BBC Board interact in practice. The names of the directors of the commercial subsidiary companies can only be found on the Companies House website or within the relevant commercial subsidiary annual reports. While the BBC Studios website contains information about the membership of BBC Studios Executive Committee, there is no information regarding the Commercial Holdings Board, and the main BBC website does not provide much information about the governance of the commercial subsidiaries.<sup>48</sup>
- 2.42 Given the obligation in the Agreement that the BBC must not directly undertake any commercial activities (and that they must be undertaken by commercial subsidiaries), to ensure that the relationship is at an arm's length<sup>49</sup> we expect the governance of the commercial subsidiaries to be effective, robust and sufficiently separate from the Public Service.

<sup>47</sup> National Audit Office, *The BBC's commercial activities: a landscape review*. <https://www.nao.org.uk/wp-content/uploads/2018/03/The-BBCs-commercial-activities-a-landscape-review.pdf>, page 19.

<sup>48</sup> <https://www.bbcstudios.com/executive-committee/> (accessed 27 July 2018).

<sup>49</sup> The Agreement, section 23, paragraph (4).

- 2.43 In light of the Agreement and our competition concerns (see paragraphs 2.12-2.13), our requirements state the BBC must ensure distinct and separate governance of the commercial subsidiaries and adds that there should be an appropriate number of directors who are separate from the BBC Board and its executive committees.
- 2.44 Given that the activities of the commercial services are required to fit with the BBC's Mission and Public Purposes, we are mindful that there are legitimate reasons why the BBC Board should have some influence over the commercial subsidiaries. It is therefore appropriate and necessary for the BBC Board to have a certain level of input into the strategy and participation in the governance of the commercial subsidiaries.

## Our proposals on governance

- 2.45 We plan to retain the 2017 Requirements on governance with no substantive modifications.<sup>50</sup> We consider that these requirements are important given our competition concerns arising from the BBC's governance arrangements.
- 2.46 It is for the BBC Board to decide how to structure the boards and executive committees of the commercial subsidiaries in a way that complies with our requirements. We note that the structure of the BBC's commercial operations has been going through a period of change as a result of the recent merger between the old BBC Studios and BBC Worldwide. We also note that the Commercial Holdings Board has recently been strengthened to become the main governance body for the commercial operations and that the BBC is undertaking a review to consider the appropriate composition of the Commercial Holdings Board.
- 2.47 We will monitor the BBC's compliance as its governance arrangements evolve. In doing so we will focus on the balance between non-executive and executive directors, whether the chair is independent, the extent of overlap in membership between the Commercial Holdings Board and the BBC Board and Public Service executive committees, and the degree of influence that the Public Service has on commercial subsidiary governance and decision making.
- 2.48 We also make below some proposals on conflicts of interest arising from cross-directorships and transparency.

### Conflicts of interest

- 2.49 There are a number of cross-directorships, where BBC Board members and/or Public Service executives also sit on the commercial subsidiary boards and/or executive committees. We expect that the BBC will have processes in place to manage potential

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<sup>50</sup> We are making some changes to the 2017 Requirements to make them clearer, more precise and less repetitive.

- conflicts of interest arising from cross-directorships, so that it can ensure it is meeting our existing requirements.<sup>51</sup>
- 2.50 Given the range of cross-directorships, conflicts of interest may arise at the Commercial Holdings Board and BBC executive committee levels, in addition to the BBC Board level. Therefore, we propose to amend the conflicts of interest requirement to make clear that it applies to members of the Public Service and commercial subsidiary executive committees, in addition to members of boards.<sup>52</sup>
- 2.51 We consider that more information is required so that we can understand how the BBC has implemented our current requirement relating to the management of conflicts of interest arising from cross-directorships. As stated above, we propose that the Annual Statement on Operational Separation should include a description of the relevant measures, controls and processes in place to identify and manage conflicts of interest and the risks of information sharing that may arise from cross-directorships.
- 2.52 While the BBC has general guidance on conflicts of interest for staff and a BBC Board Code of Practice,<sup>53</sup> we have not seen guidance on conflicts of interest specific to cross-directorships. We would expect the Annual Statement to outline any guidance that the BBC has put in place for directors of all relevant governance bodies which specifically addresses the cross-directorship risks and competition concerns detailed above.
- 2.53 Furthermore, we propose to introduce a new reporting requirement for the BBC to provide us with details of any potential or actual conflicts of interest relevant to operational separation recorded and addressed in the previous year.<sup>54</sup> This information will give us an understanding of when, how often and what types of conflicts arise, on which governance bodies and how they are managed by the BBC. We propose to only require the BBC to provide us with details of specific conflicts of interest (rather than requiring external publication), given they may relate to confidential information. This information will provide us with some insight into how BBC is complying with the conflicts of interest requirement, which is an important requirement in addressing our competition concerns in relation to cross-directorships. In line with our proposed amendment to the conflicts of interest requirement set out above, this reporting requirement would relate to all governance bodies for the Public Service and commercial subsidiaries where there are cross-directorships, including the Commercial Holdings Board.<sup>55</sup>

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<sup>51</sup> In the Commitments, the BBC said it would maintain its rigorous conflict of interest procedures. It also said that where executives of the BBC's commercial subsidiaries are also directors of the Corporation's main Board or Executive Committee, the BBC will ensure that they do not participate in discussions or decisions about individual programme commissions or tendering decisions for the Public Service.

<sup>52</sup> The proposed modification is set out in requirement A.5 of Annex 1.

<sup>53</sup> BBC Board Regulation: Board Code of Practice,

[http://downloads.bbc.co.uk/aboutthebbc/insidethebbc/managementstructure/boardregsandpolicies/board\\_code\\_of\\_practice.pdf](http://downloads.bbc.co.uk/aboutthebbc/insidethebbc/managementstructure/boardregsandpolicies/board_code_of_practice.pdf).

<sup>54</sup> The BBC has an existing Commitment to record identified conflicts of interest in the minutes of BBC Board meetings, which are published on the BBC's main website.

<sup>55</sup> The proposed reporting requirement is set out in D.3 in Annex 1. This information should be provided to Ofcom at the same time as the BBC Annual Report and Accounts is published.

## Transparency on governance

- 2.54 We consider that the governance of the BBC's commercial subsidiaries could be more transparent and so welcome the BBC's review of transparency in relation to commercial activities (as discussed in Section 1).<sup>56</sup> As mentioned above, there is limited information in the public domain regarding governance of the commercial subsidiaries. To mitigate our concerns, we propose to introduce a requirement that the BBC increase transparency regarding:
- i) the roles, responsibilities and remit of the Commercial Holdings Board (and other commercial subsidiary governance bodies) as a whole, and its individual members, including whether they are Public Service or commercial employees. The BBC should provide and update information about the terms of reference and membership of commercial subsidiary governance bodies) on an ongoing basis on appropriate BBC website(s); and
  - ii) the reporting lines and relationship between the Commercial Holdings Board, the BBC Board, the BBC Executive Committee and other commercial subsidiary governance bodies. The BBC should provide and update information about the reporting lines of commercial subsidiary governance bodies on an ongoing basis on appropriate BBC website(s).
- 2.55 We propose that this information should be published as we do not consider that there is any reason for it to be treated as confidential. We also consider that it is important that stakeholders have easy access to information regarding the governance of the commercial subsidiaries.<sup>57</sup>

## Consultation question

Question 2.1 Do you agree with our proposals on operational separation including the proposed changes to the requirements and guidance? Do you agree with our proposal for a new requirement on the BBC to publish an Annual Statement on Operational Separation? Please provide reasons and evidence to support your answer.

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<sup>56</sup> See 'Transparency Review Terms of Reference' The BBC <https://www.bbc.co.uk/mediacentre/statements/transparency-review-terms-of-reference>.

<sup>57</sup> The proposed transparency requirement is set out in D.4 in Annex 1. This requires annual publication of the information alongside a duty to keep the information updated on an ongoing basis.

## 3. Supply and pricing of goods and services

### Introduction

- 3.1 The BBC sells a range of goods and services to the market and its commercial subsidiaries. This includes licence fee funded content which could be sold to its commercial subsidiaries and/or other market participants and the provision of business support services (such as HR, IT, legal and finance) which are only shared within the BBC Group. The 2017 Requirements set out a number of obligations on the Public Service in relation to the price and non-price terms and conditions of goods and services which cross the Public Service boundary.<sup>58</sup>
- 3.2 The 2017 Requirements were based on the rules that were previously in place as set by the BBC Trust. We said at the time that we would look in detail at the BBC's pricing arrangements and whether as a result of that work any changes were required to the trading and separation requirements. We have since developed a better understanding of the range of pricing arrangements that are in place, the extent of the products supplied by the Public Service to its commercial subsidiaries, and some issues arising from the practical implementation of our 2017 Requirements. We have also discussed the 2017 Requirements with a number of stakeholders to understand how they are working in practice.
- 3.3 As a result, we consider that it remains necessary to have rules in place to ensure that the Public Service supplies goods and services on an arm's length and non-discriminatory basis. However, we believe that some modifications to aspects of the 2017 Requirements are necessary to allow for different approaches to be taken given the nature of the goods and services provided and the related competition concerns.
- 3.4 We propose that the Public Service should set prices for goods and services based either on the relevant market price or market benchmark as appropriate. As there may be instances where market information is not available, or it would be disproportionate to undertake specific benchmarking (i.e. for one off, immaterial transactions), we propose retaining the fall back option of setting prices based on costs where there is no available, reliable, market information. We are interested in stakeholder views on this proposal.
- 3.5 However, we propose that the Public Service should set prices based on long-run cost where it provides business support functions, such as HR, IT, legal and finance, that it shares only within the BBC Group, and it would not otherwise supply externally. These functions are incidental to the Public Service carrying out its core activities (i.e. delivering the Mission and Public Purposes).
- 3.6 Pricing for tickets to certain Public Service events that are sold to the general public will continue to be exempt from the pricing rules.

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<sup>58</sup> By that we mean goods and services which are supplied from the Public Service to its commercial subsidiaries, and those which are supplied from the commercial subsidiaries to the Public Services.

- 3.7 We consider that the proposed modifications should make the pricing requirements more practicable for the BBC and easier for the BBC and other stakeholders to understand.
- 3.8 In the remainder of this section we set out the 2017 Requirements, our competition concerns and then discuss our proposed approach and the resulting proposals for modifications to the 2017 Requirements. We welcome views on all elements of our proposals and highlight three specific questions for stakeholders to consider in their responses.

## Current requirements

- 3.9 In addition to obligations requiring the supply of goods and services to be on arm's length and commercial and non-discriminatory terms, the Public Service is required to set market prices for goods and services supplied to commercial subsidiaries or third parties using an open market process, where appropriate. However, the 2017 Requirements recognise that for some types of goods or services it is not always possible or practicable to derive a market price in this way, and that absent an open market process, prices and terms must be set using benchmarking of market prices or market practices.
- 3.10 Where market pricing or benchmarking are not possible, the Public Service must set prices using a cost-based approach. The 2017 Requirements set out that these costs should cover direct costs, an appropriate contribution to relevant overheads and capital costs, and an appropriate contribution for reinvestment in Public Service activities. The 2017 Requirements also specified that where the Public Service is using a cost-based approach, it must only set prices at the level of incremental cost in exceptional circumstances and cannot price below incremental costs under any circumstances.<sup>59</sup>
- 3.11 The 2017 Requirements also state that the BBC must use consistent pricing approaches for similar goods and services including the BBC brands.<sup>60</sup>

## Competition concerns

- 3.12 As discussed in Section 1, our role in relation to the BBC's commercial subsidiaries is to ensure that they do not have an unfair advantage or distort the market as a result of their relationship with the Public Service. In addition, we seek to protect fair and effective competition where the Public Service supplies products to third parties.
- 3.13 Our pricing requirements, also known as transfer pricing requirements, operate in conjunction with the requirements on commercial rates of return to guard against a distortion to fair and effective competition. We will usually consider a commercial activity's

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<sup>59</sup> The requirement that arrangements are made on arm's length commercial terms also applies to transactions where the Public Service is buying goods and services from its commercial subsidiaries.

<sup>60</sup> In addition, in the Commitments the BBC committed to apply pricing methodologies consistently across all the commercial subsidiaries and the lines of business within its commercial arm and that it would set out in its published documents how payment for the use of the brands applies to different commercial activities.

rate of return in combination with pricing to assess whether the relationship between the Public Service and the commercial activity has had a market distorting effect.

- 3.14 In relation to how the BBC supplies products<sup>61</sup> to others, we have identified the following risks:
- a) Pricing – there is a risk that the Public Service sets prices for products which are supplied as inputs to its commercial subsidiaries which are too low. This could allow the commercial subsidiaries to set lower prices that distort the market and/or provide them with an unfair advantage over rival suppliers. Alternatively, the Public Service could set prices for inputs to its commercial subsidiaries and third parties which are too low across the board which could disadvantage other commercial suppliers in a way that harms fair and effective competition because those suppliers cannot match the Public Service prices; and
  - b) Discrimination – there is a risk that the Public Service discriminates in the prices or terms and conditions it offers for products supplied as inputs to its commercial subsidiaries compared to third parties in a way that distorts the market and/or provides an unfair advantage. Alternatively, the Public Service could discriminate between different third parties in a way that harms fair and effective competition (because one party has better terms than the other which could translate into lower prices for the products it sells downstream).
- 3.15 Where the Public Service buys products from its commercial subsidiaries, an unfair competitive advantage could arise if the Public Service paid a price that is too high compared to the market. This could allow the commercial subsidiaries to set lower prices that distort the market in other products and services in such a way that harms fair and effective competition or enables the returns of the subsidiaries to be artificially high.

## Our approach and proposals

### Supply of products from the Public Service to commercial subsidiaries and third parties

#### Market-based pricing rule

- 3.16 Given our competition concerns discussed above, the objectives of the transfer pricing requirements are to ensure that the commercial subsidiaries pay a “fair” price for any inputs they receive from the Public Service. For instance, they pay a price which reflects what third parties would have to pay for equivalent inputs. Equally, this also means that the commercial subsidiaries receive a fair price for any outputs they provide to the Public Service. This should ensure that the commercial subsidiaries are operating on a level playing field compared to other similar rivals.

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<sup>61</sup> We refer to the combination of assets, services and goods that the Public Service sells to its commercial subsidiaries and/or third parties as “products” throughout this section.

- 3.17 We consider that a “competition on the merits” approach is the relevant starting point for considering how a significant, publicly-funded organisation, such as the BBC, should operate with respect to setting prices for products sold to both its commercial subsidiaries and third parties. This approach allows the commercial subsidiaries to benefit from certain legitimate advantages of scale and/or scope enjoyed by the Public Service provided that those advantages are replicable by comparable third parties.
- 3.18 We also approach transfer pricing from the perspective of the Public Service acting as a “seller” and not from the perspective of the recipient as the “buyer” because we are setting requirements for what the Public Service should charge. Similarly, where the Public Service is buying products from its commercial subsidiaries, we approach this from the perspective of what the Public Service should pay.
- 3.19 Where the Public Service is supplying products to others, we consider that the relevant economic concept for the pricing of those products is the “opportunity cost” to the Public Service.<sup>62</sup> Given the position of the Public Service in terms of providing inputs to downstream operations, the use of the opportunity cost approach best reflects the operation of an undistorted, competitive market in which firms are acting rationally and not strategically. In other words, we would not expect a rational firm to set prices (for intercompany transfers or otherwise) in such a way as to fulfil strategic aims such as improving the profitability of commercial subsidiaries. A hypothetical rational commercial rival to the Public Service would not sell a product to its commercial subsidiary unless it received a price at least as high as it could get from supplying a third party. Equally, for products that it would not supply to third parties, it would only supply them to its commercial subsidiaries if the price at least covered the incremental (or avoidable) costs it incurs from providing the product.
- 3.20 This means that when the Public Service is making decisions about pricing it should consider the potential alternatives when supplying the product in question, namely whether it could sell the product to someone else or whether it would stop or scale back the activity that provides the product. The opportunity cost to the Public Service is then either the revenue foregone from not selling the product to someone else or the long-run costs incurred in providing the product.
- 3.21 Other than the exception discussed below for shared business support services that are only supplied to the BBC Group, this approach means that the Public Service should set transfer prices based on market prices, with those prices representing the revenue forgone from not selling the product to another company. We consider that this approach should apply where the Public Service supplies products to its commercial subsidiaries and/or third parties where the alternative choice is for the Public Service to sell the product to an alternative customer. In many cases these products have been generated by the Public Service conducting its core public purpose activities, for example content and other intellectual property such as the BBC brands. We would expect all supply of content rights

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<sup>62</sup> The opportunity cost reflects what the Public Service is giving up by choosing to supply a good or service to a particular party.

and licensing of the BBC brands to be priced at a market rate. We discuss BBC brands further below.

### *BBC Brands*

- 3.22 The BBC brand is one of the most recognisable media brands in the world<sup>63</sup> and its development and maintenance has been funded by the licence fee. The commercial subsidiaries use the BBC brands in terms of their corporate names (e.g. BBC Studios) and the goods and services they offer (e.g. BBC Earth).
- 3.23 The relevant opportunity cost for the BBC brands would be what a third party might be willing to pay to use it, taking into account any restrictions the Public Service might reasonably impose to protect the reputation and value of the BBC brands.
- 3.24 On this basis the value of the BBC brands should be determined by market pricing (either through a competitive process if the BBC licenses the brands externally, or through market benchmarking).
- 3.25 We recognise that this is an area where establishing an appropriate transfer price may be difficult. We note that the current approach set out in the BBC's transfer pricing methodology manuals sets transfer prices for the use of the BBC brands as a proportion of the revenues that are directly linked to the use of the brands (e.g. BBC Studios competing for commissions from third party broadcasters). This could be a reasonable proxy for the value of the use of the brands.

Consultation Question 3.1: Do you agree with our proposal that transfer prices for use of the BBC brands should be based on market prices? Please provide reasons and evidence to support your answer.

### *Identifying Market Prices*

- 3.26 There may be a number of ways for the BBC to identify the market price and we recognise that it is likely to be easier to determine for products that the Public Service already provides to the market than where this is not the case. Where the Public Service does not already know what the market price should be it can be determined through an open market process or through market benchmarking (which may also include research into market practices).
- 3.27 One way of determining market prices is to put the good or service out to open tender. If one of the commercial subsidiaries was successful at winning the tender, it would demonstrate that that commercial subsidiary placed the most value on the good or service in question. The Public Service would then earn the highest possible revenue and there would be no concern about discrimination or that the commercial subsidiary received an unfair competitive advantage.

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<sup>63</sup> It was valued as the 10<sup>th</sup> most valuable media brand in the world – Brand Finance 2018  
[http://brandirectory.com/league\\_tables/table/global-500-2018](http://brandirectory.com/league_tables/table/global-500-2018).

- 3.28 However, we also recognise that it is not always practicable to tender goods and services. Another way of determining market prices is for the BBC to establish what a market price would be through benchmarking of suitable comparators. A previous open market process may be an important input into establishing relevant market benchmarks for use in transfer pricing between the Public Service and its commercial subsidiaries as actual sales to third parties would be considered a legitimate source of benchmarking data.
- 3.29 Where the Public Service relies on market benchmarking, the key issue will be the process for deriving the market benchmark – for example how representative and how current the benchmark is. One of the main considerations in determining the validity of market benchmarks will be the frequency with which they are reviewed. Where the BBC makes use of market benchmarks, it should ensure that they are regularly reviewed in line with market practices and be able to demonstrate that the data is relevant and up to date, taking account of, for example, the nature and duration of the underlying arrangements.<sup>64</sup>
- 3.30 We consider that it is appropriate to give equal weight to market benchmarking as a way for the Public Service to identify a market-based price in the proposed modifications to the requirements rather than maintain the current hierarchy which requires the BBC to first consider an open market process.
- 3.31 Given the importance of market-based pricing and bearing in mind that we consider that there are a number of ways for the BBC to identify what the market price should be (e.g. open market processes, previous similar sales, benchmarking), we have considered whether it would be appropriate to remove the option for the BBC to base prices on costs incurred by the Public Service. However, there may be some rare cases where the Public Service is unable to identify appropriate, reliable benchmarking data or where it may not be proportionate to undertake benchmarking, for example for immaterial, one off transactions. We therefore propose to retain the option to use long-run costs in the absence of other market information. In these instances, we would expect that the long-run cost is being used as a proxy for the market price. As such, we would expect that the price includes a mark-up on costs and we do not propose to amend the method for calculating costs (i.e. the price should reflect long-run direct costs, an appropriate contribution to relevant overheads and capital costs, and an appropriate contribution for reinvestment in Public Service activities).<sup>65</sup>
- 3.32 We propose that where the Public Service provides products to third parties and/or commercial subsidiaries (apart from in relation to shared business support functions discussed below) prices should be set based on market prices (set through open market processes or benchmarking). We also propose to retain the ability for the BBC to set cost-based transfer prices in the absence of market information or where it is disproportionate to undertake specific benchmarking exercises (i.e. for immaterial, one off transactions).<sup>66</sup>

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<sup>64</sup> The proposed requirements are set out in paragraph B.6(b) in Annex 1. We also propose further guidance on this in paragraphs B.17-B.20 in Annex 1.

<sup>65</sup> As set out in paragraph B.3 in Annex 1, we are proposing that the BBC can only base prices on long-run incremental costs where it can demonstrate that this conforms to market practice.

<sup>66</sup> The proposed requirement is set out at Annex 1, paragraph B.3.

Consultation Question 3.2:

Do you agree with our proposals that:

- a) it is appropriate to retain the ability for the BBC to set prices based on costs in the absence of market information or where benchmarking would not be proportionate; and
- b) the calculation of cost in these circumstances should include direct costs, overheads and a contribution to the Public Service.

Please provide reasons and evidence to support your answer.

### Pricing for shared business support functions

- 3.33 We consider that for business support functions which the Public Service provides to its commercial subsidiaries and which it has not, does not and is not expected to supply to third parties in future, prices should be based on long-run costs. Shared business support functions include services such as HR, IT, legal and finance. If the Public Service were to cease providing these services to its commercial subsidiaries, they would not sell them externally. In other words, the Public Service is not “in the business” of supplying HR, IT, legal and finance services to external parties. These services are not unique to the Public Service and are replicated by other providers.<sup>67</sup>
- 3.34 This is because where the alternative to the Public Service of not supplying its commercial subsidiary would be to scale back (e.g. administrative functions such as HR services) or discontinue the activity (rather than supply a third party), the opportunity cost to the Public Service would be represented by the long-run costs of providing that product.
- 3.35 The opportunity cost to the Public Service of these business support functions would be based on the long-run incremental costs of provision of these goods and/or services to its commercial subsidiaries. In this situation, cost based prices could be derived from either:
- a) the long-run incremental costs incurred by the Public Service in providing these goods and/or services; or
  - b) the long-run costs avoided if the Public Service no longer provided the goods and/or services to its commercial subsidiaries.
- 3.36 We expect that these two approaches would have equivalent outcomes. However, we recognise that in practice it may not be possible to set transfer prices on a pure, long-run incremental cost basis or that it may not be proportionate to do so. For example, reliable data may not be available on the level of the long-run incremental costs. In these cases, fully allocated costs may be a reasonable proxy for long-run incremental costs.
- 3.37 Where the BBC has procured a contract on behalf of BBC Group, a key element of transfer pricing is to ensure that at a minimum an appropriate increment of the contract cost is charged to its commercial subsidiaries.

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<sup>67</sup> The proposed requirement is set out at Annex 1, in paragraph B.4.

- 3.38 We note that the BBC already derives market benchmarks to establish a pricing range for some of these shared business support services as part of its “compete and compare” programme<sup>68</sup> so in practice a price based on the long-run cost of provision is likely to be the same or very similar to a market-based price in these cases.
- 3.39 We propose that for the shared business support services described above, the Public Service should set its transfer prices based on the costs that the Public Service incurs to provide these service(s) to its commercial subsidiaries. We do not propose to provide an exhaustive list of shared support services in the requirements but provide the explanation above as guidance.<sup>69</sup>

Consultation Question 3.3: Do you agree with our proposals for transfer pricing of shared business support services? Please provide reasons and evidence to support your answer.

### Supply of products from the commercial subsidiaries to the Public Service

- 3.40 In a number of instances, the commercial subsidiaries supply products to the Public Service e.g. studio capacity by BBC Studioworks, some news programming from BBC Global News to BBC News.
- 3.41 As explained above, in this situation our competition concern is that the Public Service could use its special funding position to pay inflated prices for products supplied by its commercial subsidiaries and so confer an unfair advantage on them by boosting their revenues and overall rates of return.
- 3.42 The 2017 Requirements were not completely clear that the transfer pricing rules applied in this direction across the boundary. We are therefore proposing to modify the requirements to make this clearer. In addition, we propose that when supplying products to the Public Service the price the Public Service pays should not exceed market prices or market benchmarks. As explained above, if the commercial subsidiaries are making use of market benchmarks then those benchmarks should be relevant, verifiable and reviewed regularly.<sup>70</sup>
- 3.43 We consider that these proposed requirements should not apply to the supply of original programming and content by BBC Studios to the Public Service through the commissioning process because those prices are set in light of published tariffs and the BBC has a requirement to commission on fair, reasonable, non-discriminatory and transparent terms.

### Other proposed modifications to the requirements and guidance

- 3.44 We do not propose to adjust the requirements not to unduly discriminate, however we note that the existing pricing requirements contain the following two provisions which may appear on their face to be inconsistent:

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<sup>68</sup> See: <https://www.bbc.co.uk/mediacentre/speeches/2014/dg-city-university>.

<sup>69</sup> The proposed requirement is set out at Annex 1, paragraph B.4.

<sup>70</sup> The proposed requirement is set out at Annex 1, paragraph B.5.

- a) the obligation to make goods and services available to third parties on *equivalent* terms and prices to those offered to its commercial subsidiaries; and
- b) the obligation not to discriminate *unduly* against or between third parties.

- 3.45 We recognise that in some cases there may be a fair and objective justification for offering different prices to different parties or refusing to supply to certain parties.<sup>71</sup> To reflect that approach in our requirements, we propose to delete the reference to equivalent terms and prices and instead require that the BBC must not discriminate unduly against or between third parties as to terms and prices on which goods and/or services are offered.<sup>72</sup>
- 3.46 In our proposed guidance<sup>73</sup> we explain that given our competition concerns set out above are in relation to the commercial subsidiaries gaining an unfair competitive advantage, the BBC can set transfer prices for products supplied to its commercial subsidiaries that are higher than the market price or cost (depending on the methodology used), if it wishes to do so.
- 3.47 In addition, we have made it explicit in the proposed changes to the requirements and guidance in Annex 1 where they also apply to joint ventures that the commercial subsidiaries participate in.
- 3.48 We are also proposing some new reporting requirements on the BBC to report actual transfer charges levied on the commercial subsidiaries. These proposals are set out in Section 5.

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<sup>71</sup> 2017 Requirements, paragraph 3.37, and reflected in the proposed guidance at Annex 1, paragraph B.13.

<sup>72</sup> The proposed requirement is set out at Annex 1, paragraph B.2.

<sup>73</sup> This proposed guidance is set out at Annex 1, paragraph B.28.

## 4. Commercial rate of return

### Introduction

- 4.1 The rate of return requirements, in conjunction with our transfer pricing rules, act as an important safeguard to prevent the commercial subsidiaries from gaining an unfair competitive advantage or distorting the market due to their relationship with the Public Service.
- 4.2 These requirements help to ensure that the Public Service acts like a rational private investor, so that it does not use its special position to sustain loss making commercial activities, for example, activities that are inefficient and that a commercial rival would otherwise have modified, scaled back, stopped or divested. The requirements also reinforce the principle that commercial activities are undertaken at arm's length and on commercial terms in accordance with normal market principles. For example, not earning an appropriate commercial rate of return may mean that the commercial subsidiaries are setting prices which are too low and not reflective of their costs and/or the value of their goods and services. Such prices may distort the ability of customers to use price information to make efficient choices (e.g. choose to purchase services from the most efficient provider) and reduce the ability of their rivals to compete effectively.
- 4.3 Where a commercial subsidiary would fail to make an adequate return if transfers of goods and services from the Public Service to the subsidiary are priced appropriately, there is a risk that the Public Service may, directly or indirectly, support the subsidiary.
- 4.4 In this section, we set out our proposed modifications to the rate of return requirements and accompanying guidance following our analysis and discussions with stakeholders. We propose to amend elements of these requirements and guidance to ensure that stakeholders better understand our approach, in particular that:
- a) the requirement to earn a commercial rate of return applies to each subsidiary and line of business within it;
  - b) a commercial rate of return should be earned and assessed over an appropriate time period; and
  - c) the BBC must take appropriate steps where its subsidiaries are not earning or expected to earn a commercial rate of return.

### Current requirements

- 4.5 The BBC is currently required to earn a commercial rate of return on its commercial activities. We also require it to assess what an appropriate commercial rate of return is for each line of business, and to consider the steps to take should a line of business not make a commercial rate of return.

4.6 In the first instance, the requirements put the onus on the BBC to determine what the lines of business and appropriate rates of return should be. We explained in our guidance that a new line of business may not make a commercial rate of return in the early years of operation. We noted that if we had concerns about the forward looking or actual rate of return, or the lines of business for which the BBC sets rates of return, we may intervene and, if appropriate, issue a direction. We also put reporting requirements in place to allow us to monitor actual performance against what the BBC has assessed as a commercial rate of return.

## Our analysis and proposals

4.7 As a result of the work carried out over the past year we now have a better understanding of the commercial activities, the BBC's own assessments of the lines of business, and the approach to considering an appropriate rate of return. Given this, we consider that clarification of some of the commercial rate of return requirements is appropriate.

### Earning, assessing and setting rate of return at the subsidiary and line of business levels

4.8 The current requirement to earn a commercial rate of return on "activities" is not sufficiently clear about what group of activities we expect the BBC to earn a commercial return on. The term commercial "activities" could be open to interpretation – for example, whether this is each individual activity or all activities in aggregate.

4.9 We do not consider that it is appropriate to impose a requirement to earn, assess or set commercial rates of return on each individual investment made by the commercial subsidiaries. We recognise that returns on individual projects will change over time and, content exploitation is often variable in success (i.e. whether a programme is a "hit" or not). It would also be very difficult for us to find and compare the BBC's returns to similar investments carried out by rivals.

4.10 However, it may also not be appropriate to assess and set the rate of return at an individual subsidiary level. The commercial subsidiaries are subject to change over time as the BBC modifies how it manages them,<sup>74</sup> and this may mean that comparison with third parties for benchmarking purposes is not always possible. For example, BBC Studios now carries out a range of commercial activities across different markets and regions throughout the world. This is likely to result in differing cost and revenue drivers which impact the returns in the different markets it operates.

4.11 In addition, if a line of business was underperforming, this might be difficult to detect if profitability was assessed at the subsidiary level. However, if the poor performance of the line of business could be addressed,<sup>75</sup> the subsidiary's returns would be improved without impacting the other lines of business. We therefore consider that it is appropriate that similar activities of the commercial subsidiaries should be grouped into lines of business.

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<sup>74</sup> For example, the recent BBC Studios and BBC Worldwide merger.

<sup>75</sup> As set out in our current and proposed guidance, poor performance could be addressed by for example, modifying, scaling back, divesting or stopping the underperforming line of business.

This approach will enable us to assess how those lines of business are performing against other similar comparators over time. This was an important element of the BBC's Commitments where we considered that we needed to continue to understand the performance of production and distribution activities separately given their different cost and profit drivers.<sup>76</sup> We continue to consider that in the first instance it is appropriate for the BBC to determine what the lines of business are, and that these should mirror the way the business is managed by the BBC.

- 4.12 Where the commercial subsidiary is relatively small in scale and carries out similar activities across regions and markets which means that those activities are subject to similar commercial pressures and risks, we consider it may be appropriate to assess the performance of the subsidiary as one line of business (e.g. BBC Studioworks).
- 4.13 Where there are multiple lines of business within a subsidiary, in addition to considering appropriate rates of return at the line of business level, we also plan to monitor the rate of return at the subsidiary level. This is to ensure that where there are costs that the BBC is unable to allocate to a line of business, overall the commercial subsidiary is generating a commercial rate of return.
- 4.14 We also propose to reflect this clarification in the remainder of the rate of return requirements by making the following modifications:
- a) The obligation to assess and set the commercial rates of return applies at the level of each commercial subsidiary and each line of business within the commercial subsidiaries.
  - b) The process that the BBC must follow where commercial rates of return are not generated applies at the level of each commercial subsidiary and each line of business within the commercial subsidiaries.<sup>77</sup>

#### **Assessment over an appropriate time period**

- 4.15 We consider that an assessment of rates of return must be carried out over an appropriate period of time. What that time period is will vary depending on the characteristics and nature of the activities within the lines of business, as well as how mature the line of business is (i.e. whether it is a new or established activity). New commercial activities may take time to build up a customer base and/or achieve efficiencies and have lower profitability in early years as they incur costs to grow the business. In order to determine what a commercial rate of return is and therefore whether it is in line with market norms, the BBC should identify appropriate benchmarks considering the characteristics of the line

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<sup>76</sup> The Commitments set out that the BBC will set targets for the following lines of business within BBC Studios: UK television production, International production and formats, Content sales, Branded services and Consumer products. The BBC also committed to only altering the internal allocation of revenues and costs between the production and distribution divisions of BBC Studios in order to align with market norms and that it will inform Ofcom of any such changes. This means that there continues to be five lines of business within the merged BBC Studios, including separate lines of business for production and distribution activities. The BBC Global News and BBC Studioworks subsidiaries only have one line of business each.

<sup>77</sup> The proposed requirements are set out at Annex 1, paragraphs C.1 to C.3.

of business and the market in which it operates. We recognise that it may take a number of years for the some of the more immature BBC lines of business to achieve the benchmark commercial rate of return, but the trajectory towards this benchmark return should be reflected in an appropriate business plan.

- 4.16 The current requirements do not specify that a commercial rate of return should be earned over an appropriate period of time. We propose to adjust the requirement to make this clear and to ensure that the requirement is not interpreted in such a way that implies that the BBC either has to make a commercial rate of return over a very short or very long time period.<sup>78</sup>

#### **Implementation of steps where the BBC considers a commercial activity is not likely to earn a commercial rate of return**

- 4.17 The current requirements state that when the BBC identifies a line of business that is not earning a commercial rate of return, it must review performance and consider any necessary steps to move to earning a commercial rate of return. We propose to clarify that the BBC should carry out this review when it identifies a line of business is not *likely* to earn a commercial rate of return rather than just waiting until a line of business is not making the rate of return. Further, we do not consider that it is enough for the BBC to just consider the steps, instead it should implement those steps (as soon as practicable) in order to move to earning a commercial rate of return. Accordingly, we have proposed to update the requirements to reflect that.<sup>79</sup> This modification should help to ensure that the BBC does not carry on activities that are not likely to earn a commercial rate of return.
- 4.18 The current requirements also state that the BBC is required to inform Ofcom when it identifies a line of business is not earning a commercial rate of return and provide its business plan showing how it expects the line of business will achieve the commercial rate of return. This provides an early warning to us and seeks to ensure that we have an understanding of how the BBC proposes to remedy the situation. We do not propose to make substantive changes to this requirement but given that these are reporting obligations, we have included them together with other monitoring, reporting and transparency requirements.<sup>80</sup>
- 4.19 Reporting requirements to allow us to monitor the BBC commercial activities' actual and benchmark rates of return are set out in Section 5.

#### **Setting appropriate lines of business and informing Ofcom of any changes**

- 4.20 In the current guidance, we note that the BBC must propose to Ofcom how it would define specific lines of business comprised within its commercial subsidiaries.<sup>81</sup> The BBC has now made proposals in this regard which are also captured in the commitments that the BBC

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<sup>78</sup> The proposed requirements are set out at Annex 1, paragraphs C.1 to C.2.

<sup>79</sup> The proposed requirement is set out at Annex 1, paragraph C.3.

<sup>80</sup> See related proposed requirements set out at Annex 1, paragraphs D.12, D.16.

<sup>81</sup> See paragraph 3.52 of the 2017 Requirements.

has given in relation to the merged BBC Studios. We therefore propose to require the BBC inform Ofcom of any changes that it makes to the current lines of business within its commercial subsidiaries.<sup>82</sup>

## Our proposals to modify the guidance

4.21 In addition to the above proposed modifications to the requirements, we propose to make the following changes to the accompanying guidance to ensure that the requirements and guidance are consistent:

- a) We propose to make clear that when the BBC sets its target commercial rate of return, it should do so with reference to rate of return benchmarking where possible. Given that we require the commercial rate of return to represent market norms, the BBC should benchmark its lines of business against the most comparable rivals it can identify based on the activities it undertakes and the market in which they are operating.<sup>83</sup>
- b) Where the BBC is not able to use or source appropriate benchmarking data or wishes to supplement benchmarking with other data sources, the BBC is free to use any other information available to it to assess whether its lines of business are making returns in line with market norms.
- c) The reference to monitoring and researching the markets in which it operates for the purposes of assessing appropriate commercial rates of return is currently set out in the requirements, but we consider that it would be more appropriate to include it as part of our guidance.<sup>84</sup>
- d) In the current guidance, we explain that in complying with our requirements “it would not be sufficient for the BBC to just demonstrate that overall a commercial subsidiary was earning a commercial rate of return.”<sup>85</sup> Given a subsidiary may only have one line of business, to avoid any confusion, we propose to remove this wording from the guidance.
- e) In the current guidance, we state that “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.”<sup>86</sup> Given the clarification above, namely that our focus is on both returns at the commercial subsidiary level and at the line of business level, we propose to remove this wording from our guidance.
- f) In the current guidance, we state that 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

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<sup>82</sup> The proposed requirements set out at Annex 1, paragraph C.4(b).

<sup>83</sup> The proposed guidance is set out at Annex 1, paragraph C.10.

<sup>84</sup> The proposed guidance is set out at Annex 1, paragraph C.10.

<sup>85</sup> See paragraph 3.52 of the 2017 Requirements.

<sup>86</sup> See paragraph 3.54 of the 2017 Requirements.

want to understand why the BBC had chosen to deliver against the Public Purposes in that way.<sup>87</sup> Given that commercial activities must be separate from the delivery of the Public Purposes and are only required to fit with the Mission and Public Purposes, we will make clear that a non-commercial rate of return cannot be justified on the grounds of assisting the delivery of the Public Purposes. However, in considering whether to investigate a potential breach of the rate of return requirements and whether to impose a penalty in the event that a breach is found, we will take into consideration, among other factors set out in our Enforcement Procedures,<sup>88</sup> any link between the commercial activity in question and the other activities carried out by the BBC which are subject to the regulatory regimes established by the Operating Framework.

- g) In the current guidance, we outline the steps we will take if we are concerned that the commercial subsidiaries and/or lines of business are not earning a commercial rate of return, and/or that the BBC is taking insufficient steps to rectify performance.<sup>89</sup> We propose to clarify that in considering whether to open an investigation and whether to impose a penalty in the event that a breach is found, we will take into account, among other factors set out in our Enforcement Procedures, the extent of any risk of market distortion, or the commercial activity in question gaining an unfair competitive advantage, as a result of its relationship with the Public Service.<sup>90</sup>
- h) As discussed in Section 1, we have also made it clear in the guidance in Annex 1 that where a commercial subsidiary has entered into a joint venture, the revenues and costs associated with this joint venture should be included in the relevant lines of business.

## Consultation question

Question 4.1 Do you agree with our proposals to amend the rate of return requirements and guidance? Please provide reasons and evidence to support your answer.

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<sup>87</sup> See paragraph 3.57 of the 2017 Requirements.

<sup>88</sup> Statement on Procedures for enforcement of BBC competition requirements which is available at: [https://www.ofcom.org.uk/data/assets/pdf\\_file/0011/102521/Statement-on-Procedures-for-enforcement-of-BBC-competition-requirements.pdf](https://www.ofcom.org.uk/data/assets/pdf_file/0011/102521/Statement-on-Procedures-for-enforcement-of-BBC-competition-requirements.pdf).

<sup>89</sup> See paragraph 3.64 of the 2017 Requirements.

<sup>90</sup> The proposed guidance is set out at Annex 1, paragraph C.15.

## 5. Monitoring, reporting and transparency

### Introduction

- 5.1 The monitoring, reporting and transparency requirements (“reporting requirements”) support the other substantive requirements. They enable us to monitor the effectiveness of the other requirements and provide stakeholders with relevant information and transparency of the BBC's activities.
- 5.2 We said in the 2017 Requirements that reporting was an area that was likely to evolve over time as we develop our understanding of the BBC's processes and practices for its commercial subsidiaries and their relationship with the Public Service.
- 5.3 Since the 2017 Requirements came into effect, the BBC has published and submitted information to us to comply with the reporting requirements. We have engaged with the BBC to improve our understanding of its businesses, activities and how the relationship between the Public Service and the commercial subsidiaries works in practice. We have also engaged with other stakeholders and considered the concerns they have about the reporting requirements and the information the BBC has published.
- 5.4 In considering whether we need to modify the reporting requirements, we have assessed the information we currently receive from the BBC against what we consider is required to monitor the other substantive requirements. We have also reviewed the information that the BBC publishes as part of its statutory and other regulatory obligations.
- 5.5 This exercise has led us to identify gaps in the existing reporting requirements and areas where further information or explanation is required. The submissions by the BBC have also shown that we should add more specificity to the reporting requirements about the information we need. We have therefore sought to provide additional clarity in the modified requirements.<sup>91</sup>
- 5.6 We have also identified some areas where we do not require the information at the frequency currently set out in the requirements. For example, we consider that we do not need any quarterly financial reporting to fulfil our duties so we propose to reduce the frequency of reporting.
- 5.7 We make our proposals in respect of the reporting requirements on the basis that the substantive requirements in Sections 2 to 4<sup>92</sup> are amended as proposed. If, as a result of the consultation responses, we make changes to our original proposals, we will make sure that our decisions in respect of the reporting requirements are aligned.
- 5.8 For each substantive requirement, we set out:

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<sup>91</sup> We summarise the proposed reporting requirements in Tables 5.1 to 5.3 at the end of this section. These tables include references to the relevant proposed requirements and guidance at Annex 1, Section D.

<sup>92</sup> The requirements and related reporting in relation to operational separation is covered in detail in Section 2. For completeness, we include the proposed requirements in the summary table at the end of this section.

- a) The information we consider we need to fulfil our duties;
  - b) The extent to which the BBC already provides this information, for example, in its statutory reporting or in the existing reporting requirements, and where there are gaps in the information provided;
  - c) Our proposed changes to the reporting requirements to fill those gaps; and
  - d) How the information should be provided including format, how often and whether it should be published or only provided to Ofcom due to any confidentiality concerns.
- 5.9 Where relevant we also discuss the level of assurance we believe is required for the proposed reporting requirements.
- 5.10 In this section we set out our proposed changes to the reporting requirements under the following headings, based on the substantive requirements discussed elsewhere in this document:
- a) Separate subsidiary;
  - b) Supply and pricing of goods and services; and
  - c) Commercial rate of return.

## Disclosure

- 5.11 As explained above, for each reporting requirement we have considered whether information should be published or only provided to Ofcom. In all cases, in light of our duty to ensure transparency our starting position is that the information should be published unless there are reasons why this would not be appropriate. For example, publication may be inappropriate if it would impact the ability of a commercial subsidiary to compete in a market.
- 5.12 We consider that the purposes of these different types of reporting are as follows:
- a) **Published information:** We consider that it is important that sufficient information is published to inform stakeholders and enable them to contribute to the development of robust regulatory decisions by allowing them to review and potentially challenge the data on which those decisions are made. Publication should also provide stakeholders with a level of assurance about the relationship of the commercial activities with the Public Service and how we are monitoring the BBC's compliance with the requirements.
  - b) **Private information:** Appropriately specified reporting requirements enable us to make informed regulatory decisions, monitor that the relationship of the commercial activities with the Public Service meets the requirements, ensure that the requirements continue to address the underlying competition concerns and help us assess any potential breaches of the requirements. We recognise that reporting cannot always provide all the information necessary to demonstrate the BBC's compliance. However, it is a useful source of information which serves as an anchor point to

reconcile other data to, which we are able to request through our formal information gathering powers to support our decision making.

## Materiality

- 5.13 We recognise that for our reporting requirements to be proportionate they must apply to material items of information. We therefore propose to require the BBC to include and/or take account of all material items of information in complying with the reporting requirements. We define a material item of information as one which is reasonably expected to affect the views of a competent user of the publications and submissions which the BBC is required to make under the reporting requirements. We do not propose to define a quantitative threshold for materiality because we consider such a fixed threshold lacks the flexibility needed when materiality is applied in different areas of reporting.
- 5.14 When considering what further information we may require for our monitoring and for transparency, for each proposed modification we have taken into account any additional reporting burden that these may place on the BBC. We have considered what information the BBC already produces and we propose to use that where appropriate. However, there are instances where we may require further detail and/or a different breakdown of the information. Where we require additional reporting, we expect the BBC to apply the materiality principle as discussed above. Where appropriate we also allow the BBC to use its judgement in defining the key categories of information it reports (subject to minimum requirements necessary for to fulfil our duties.
- 5.15 Although this may involve additional work for the BBC, we explain for each requirement below why we consider the additional reporting is proportionate. We consider further transparency about how the BBC goes about complying with our substantive requirements not only helps us monitor the compliance, but also allows other stakeholders to contribute more effectively to that process. The further transparency will also benefit the BBC as the stakeholders' confidence in its reporting and compliance is enhanced as a result.

## Scope

- 5.16 In this section and in relation to all the reporting requirements we discuss and propose, by a commercial subsidiary, we mean the commercial subsidiary itself as well as all of its subsidiaries and any joint ventures in which it may participate.

## Record keeping

- 5.17 It is important that the BBC records data and maintains those records to such an extent that it is able to comply with our substantive and reporting requirements and is also able to provide an adequate explanation of how it has complied with those requirements. We therefore propose to introduce a general record keeping requirement to that effect for the BBC (for a period of six years in line with standard practice for public companies).

## Separate subsidiary

5.18 The existing separate subsidiary requirements provide that the BBC must not directly undertake any commercial activities and therefore all commercial activities must be undertaken through the commercial subsidiaries.<sup>93</sup>

### Information we need to monitor the requirement

5.19 There is a risk that activities that should be treated as commercial activities are inappropriately treated as trading activities.<sup>94</sup> We therefore need to have a reasonable understanding of the scale and nature of the BBC's most significant trading activities.

### Assessment of information currently available

5.20 We currently require the BBC to maintain records of its trading activities but do not require that information concerning the trading activities is published or provided to us.

5.21 Revenues reported by the BBC under the trading activities with third parties would enable us to identify the most significant trading activities undertaken by the Public Service, while increases in the revenues from trading activities could be an indicator of new activities or of activities that are becoming increasingly commercial in nature. Without this information it is difficult to identify areas of interest or focus for any further review.

5.22 We note that some information on trading activities is currently provided in the notes to the accounts for the BBC Group.<sup>95</sup>

## Our proposals

### Trading activities revenues

5.23 We propose to include a general requirement for the BBC to maintain records of all of its trading and commercial activities (see previous sub section). This will replace the specific record keeping requirement for trading activities.

5.24 We also propose to require the BBC to publish annually the total revenues the Public Service receives from trading activities with third parties, split by key categories. The breakdown by activity type should, as a minimum, include royalties and rental income which we understand are currently among the key trading activities of the Public Service.

5.25 We noted above that some of this information is currently included in the BBC's statutory accounts. The BBC can continue to include this information, and refine it as needed, in the accounts for the BBC Group to comply with our proposed requirement, in which case

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<sup>93</sup> Our proposals on the operational separation requirements including reporting are set out in Section 2. We do not discuss our proposals again in this section except for the summary table at the end of this section which we include for completeness.

<sup>94</sup> As explained in Section 1, trading activities are activities undertaken by the Public Service that are commercial in nature but not treated as commercial activities. They are defined in the Agreement (Clause 31(1) and 31(2)).

<sup>95</sup> See BBC Group Annual Report and Accounts 2017/18, Note A1, page 190.

publication of an additional report will not be necessary. However, if the BBC ceases to publish this information in the accounts then it will be required to capture it in another published report.

## Supply and pricing of goods and services

5.26 As discussed in Section 3, the BBC is required to ensure that all transactions between the Public Service and the commercial subsidiaries, joint ventures and/or third parties are undertaken in accordance with our pricing requirements.

### Information we need to monitor the requirement

5.27 To establish whether the BBC's prices are in accordance with our pricing rules, we need to understand the BBC's pricing methodologies, whether those methodologies are consistent with our pricing requirements and whether the BBC applies those methodologies in practice. It is also important for us to know whether the amounts owed are paid, rather than allowed to accrue over time.

5.28 To provide context and focus for our monitoring, it is important to know which methodologies have the most impact on the charges across the BBC and understand the effects of changes to those methodologies. We therefore need to understand the scale of the transfer charges<sup>96</sup> and trends over time.

### Assessment of information currently available

5.29 We now assess the information that is currently available under the following headings:

- a) What are the BBC's chosen methodologies?
- b) Are these methodologies followed in practice?
- c) Are the methodologies used by the BBC consistent with our pricing requirements?

#### What are the BBC's chosen methodologies?

5.30 The BBC is currently required to publish annually its transfer pricing methodologies for the supply of goods and services by the Public Service to the commercial subsidiaries and the brand valuation methodologies. As part of the Commitments, the BBC also sets out its commitment to publish how payment for use of the BBC brand applies to different commercial activities. This gives Ofcom and other stakeholders valuable insight into the BBC's approach to transfer pricing.

5.31 Further, while the BBC has to notify us of any changes to the methodologies including a statement of the impact of the relevant methodological changes, this requirement alone might not provide sufficient visibility as to the reasons behind each particular change.

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<sup>96</sup> We consider that transfer charges are the actual total amounts billed for each service rather than the price as set out in the methodology manual.

- 5.32 The BBC published its latest methodology manuals in April 2018. These manuals include methodologies for goods and services supplied to commercial subsidiaries by the Public Service. The BBC also included goods and services supplied to the Public Service by the commercial subsidiaries. This provides transparency around all types of pricing methodologies for goods and services between the Public Service and commercial subsidiaries.
- 5.33 However, we currently have no transparency regarding how the Public Service charges third parties for the same goods and services that it may provide to the commercial subsidiaries. We consider that this information is important to enable us to check that the same rules are followed for the supply of goods and services to third parties as they are within the BBC i.e. that there is no undue discrimination between pricing approaches. This information will help us monitor whether prices are set in accordance with our pricing requirements.

#### Are these methodologies followed in practice?

- 5.34 The methodology manuals do not enable us to understand the relative scale of the prices and how the values change over time. Therefore, even though we can use our information gathering powers where appropriate, the lack of information makes it more difficult to identify emerging issues and could reduce the focus and effectiveness of any review.
- 5.35 The BBC's statutory reporting currently provides some high level information on the transactions between the commercial subsidiaries and the Public Service.
- 5.36 For example, the BBC Group accounts set out the different revenue sources of the Public Service and each of the subsidiaries. This also includes a line for intra-group trading to show trading within the BBC Group.<sup>97</sup> However, there is no disaggregation between the type of transactions so we are unable to understand how these intra-group trading figures are made up, or the scale of the different types of transfer charges. We are also unable to see whether these charges have actually been paid. In addition, although each subsidiary has to publish statutory accounts, these do not generally contain any information on transactions between the subsidiary and the Public Service.
- 5.37 The BBC has explained that it is relatively straightforward to provide information on the transfer charges between the commercial subsidiaries and the Public Service split by the division or department within the Public Service which provides or receives the service. However, we note that "back office" services such as HR, legal and finance all sit within one division (the 'Deputy Director General' division).
- 5.38 Further, we understand that the BBC has service level agreements (SLAs) or other contracts where transfer prices are set and charged. We expect the SLAs to be in line with the methodologies published. However, we currently do not have any transparency of how the actual transfer charges compare to the SLAs the BBC has put in place.

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<sup>97</sup> See BBC Annual Report and Accounts 2017/18, Note A1 page 191.

### Are the methodologies used by the BBC consistent with our transfer pricing requirements?

- 5.39 It is the BBC's responsibility to comply with our pricing requirements. While, we may choose in future to review the BBC's pricing methodologies from time to time, we consider it necessary to have some assurance that our requirements are being followed on an ongoing basis.
- 5.40 Although the methodology manuals provide transparency that the BBC has a process for setting the transfer prices, we cannot see whether the BBC has followed these methodologies in practice.
- 5.41 We have considered what assurance we may be able to gain from the current BBC audits in relation to whether the methodologies have been followed by the BBC. We describe the audits that the BBC currently undergoes below:
- a) Statutory audit required by the Companies Act 2006 for the financial statements of both the BBC Group and the BBC's commercial subsidiaries which gives an opinion as to whether the accounts give a true and fair view of the financial results and position.<sup>98</sup> If the BBC could demonstrate how the transfer charges are consistent with those reflected in the statutory accounts, this would provide us with some comfort that the costs have been properly extracted from the BBC accounts (see paragraph 5.56).
  - b) The independent Fair Trading Audit (currently carried out by Deloitte and reporting to the BBC Fair Trading Committee),<sup>99</sup> which provides an opinion on whether the BBC has established and applied a system of internal controls that provide reasonable assurance that the BBC has complied with its 'Fair Trading Arrangements' for the financial year.<sup>100</sup>
  - c) We understand that the BBC undertakes "dipstick testing" following the recommendation from EY<sup>101</sup> of individual transfer pricing transactions. The BBC embedded such tests in its compliance regime and has continued it through to the 2017/18 financial year. Having done this, the BBC is in the process of putting in place new measures for internal monitoring.
  - d) Regularity audit<sup>102</sup> required by the Charter and carried out by the National Audit Office, which gives an opinion as to whether the income and expenditure transactions reflected in the BBC Group's financial statements have been applied for the intended purposes and conform to the relevant framework of authorities, which includes the Charter, the Agreement, and other agreements with the Government.

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<sup>98</sup> See BBC Annual Report and Accounts 2017-18 audited by the National Audit Office, pages 160-182, [http://downloads.bbc.co.uk/aboutthebbc/insidethebbc/reports/pdf/bbc\\_annualreport\\_201718.pdf](http://downloads.bbc.co.uk/aboutthebbc/insidethebbc/reports/pdf/bbc_annualreport_201718.pdf).

<sup>99</sup> See BBC Annual Report and Accounts 2017-18, pages 121-122.

<sup>100</sup> "Fair Trading" is the BBC's terminology to reference the 2017 Requirements.

<sup>101</sup> EY report, June 2016, page 16, penultimate paragraph

[http://downloads.bbc.co.uk/bbctrust/assets/files/pdf/our\\_work/transfer\\_pricing/bbc\\_transfer\\_pricing.pdf](http://downloads.bbc.co.uk/bbctrust/assets/files/pdf/our_work/transfer_pricing/bbc_transfer_pricing.pdf).

<sup>102</sup> See BBC Annual Report and Accounts, 2017-18, page 123.

## Our proposals

### Additional clarity on the BBC's methodologies

- 5.42 To provide additional clarity regarding the BBC's transfer pricing methodologies we propose the following:

#### *Methodology manuals*

- 5.43 The pricing methodology manual must set out methodologies for pricing all goods and services including BBC brands which cross the boundary between the Public Service and its commercial subsidiaries and are subject to our transfer pricing requirements regardless of whether the Public Service is selling or buying the good or service.
- 5.44 The BBC must include in the pricing manual the methodologies applied in setting prices for third parties.

#### *Notification of changes*

- 5.45 As well as notifying Ofcom of any changes to the methodologies and their impact, the BBC must include an explanation of the reasons for those changes.

### Improved visibility of how these methodologies are applied in practice

- 5.46 To provide a better understanding of the most significant transfer pricing methodologies and their impact, we consider additional information is required on the actual transfer charges that are billed and settled between the Public Service and its commercial subsidiaries. This would allow us to review the level of transfer charges for the different categories and build up a picture of how this evolves over time. We should then be able to identify any anomalies in the level of transfer charges by different categories over time and request additional information and/or an explanation of the reasons for these anomalies from the BBC as necessary.

#### *Detailed transfer charges*

- 5.47 We propose that we receive additional reporting on the transfer charges between the Public Service and the commercial subsidiaries. The revenues from selling to third parties is covered in the reporting on trading activities (see paragraphs 5.23-5.25).
- 5.48 We therefore propose to require that the BBC should provide us with the actual charges split by the same key categories as included in its manuals. We do not consider that it would be appropriate for the BBC to provide granular transaction by transaction data for each type of charge or transaction as this would be too detailed for our needs. Therefore, the charges split by the key categories as in the BBC's manuals would be sufficient. At a minimum we propose to require key categories to include property, HR, business affairs, finance, legal and procurement.
- 5.49 We consider that this will give us enough information to monitor the actual charges, and if more granular information is required, we will be able to follow up with the BBC using our formal information gathering powers.

- 5.50 Unlike our requirement for the methodology manuals, the information on total charges must include the transactions subject to the Commissioning Requirements.<sup>103</sup> This will allow us to have a complete picture of the transfer pricing transactions between the Public Services and the commercial subsidiaries.
- 5.51 We also propose to require the BBC to provide the total contracted value of each of the key categories of transfer charges. We consider that it is an important part of our monitoring of the supply of goods and services between the Public Service and the commercial subsidiaries to compare the actual payment to the contracted amount (as per any SLA or other budgeting processes). This will enable us to have an indication of whether the BBC is being consistent between its methodologies and what prices are set and what amounts are paid.
- 5.52 We also propose to require a split of the total of all actual transfer charges into the amounts that have been paid (i.e. cash has been transferred across the boundary), written off,<sup>104</sup> and remain unpaid. We consider that having this information at a total aggregated level will enable us to monitor whether the transfer charges are genuine charges and are being settled on commercial terms.
- 5.53 In addition, we propose to require the BBC to show the amounts that were paid, unpaid or written off in relation to previous financial years where relevant.

*Overview of intragroup transactions*

- 5.54 We propose to require totals of all the intragroup transactions split by categories such as transfer charges, dividends and loans, together with information showing how the closing intercompany balances are arrived at from opening intercompany balances.
- 5.55 Our proposals will provide us with a full picture of all transactions between the Public Service and the commercial subsidiaries including the transfer charges between them to ensure that we have captured all supplies of goods and services and have transparency over the fund flows which could give rise to unfair advantage (such as loans provided on non-commercial terms). We note that some of this information is available in the statutory accounts but does not cover all the charges set out above.
- 5.56 We propose that the BBC must show how transfer charges between the Public Service and the commercial subsidiaries as reported to Ofcom (see paragraph 5.48) are treated in the BBC Group accounts. This may be in the form of consolidation workings setting out how the income statements and balance sheets of the Public Service and the commercial subsidiaries are consolidated into the BBC Group accounts for that financial year. However, we propose to leave this to the BBC to decide how best to show that the transfer charges given to us are consistent with the BBC Group accounts. This is important information to provide further assurance to us that the transfer charges are reported appropriately.

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<sup>103</sup> The Commissioning Requirements means the requirements contained in paragraph 7 of Schedule 3 of the Agreement.

<sup>104</sup> Where we refer to any charge being 'written off' we mean an instance where the amount owed is decreased for a reason other than it being paid.

## Delivery of information

- 5.57 We consider that the BBC should publish its pricing methodologies annually, alongside a notification of changes to these methodologies. The BBC should notify Ofcom of any changes and their impact biannually. We consider that receiving the methodological changes every six months will be sufficient to allow us to review the changes and raise any concerns in a timely manner. The biannual notification is also necessary to complement our other additional requirements for transfer pricing which we explain below.
- 5.58 We propose that the BBC provide us with the information on the actual transfer charges biannually. We understand that the BBC undertakes at least biannual group wide internal reporting as well as more frequent management reporting. Further, we understand that the billing and payment cycle of some of the transfer charges (property rent, HR services etc) could be monthly or quarterly. However, we consider monthly or quarterly reporting would be too frequent for our needs.

### *Published transfer charges*

- 5.59 We propose that the split of total transfer charges (into key categories and amount paid, written off and remaining unpaid), should be published annually to ensure that stakeholders are able to engage in the regulatory process and aid transparency of the general scale of transfer charges and their appropriateness.

### *Overview of intragroup transactions*

- 5.60 We expect that a full consolidation of the accounts of the commercial subsidiaries and the Public Service would only take place annually for the purposes of preparing the BBC Group accounts. Therefore, we propose to require the overview of the intragroup transactions and the treatment of those transactions in the BBC Group accounts on an annual basis. We consider that this must be provided to Ofcom only as we expect some of the detailed information on other intragroup transactions could be commercially sensitive.

## Increased confidence that the BBC's methodologies are consistent with our transfer pricing requirements

- 5.61 As noted above, we currently have only limited information to inform any assessment of whether the BBC's pricing is consistent with its methodologies.
- 5.62 One option to address this is to require the BBC to procure a third-party report to Ofcom, possibly in the form of an audit opinion or a report on the findings from the completion of tests, or agreed upon procedures, to be specified by Ofcom.
- 5.63 We have imposed similar requirements on other stakeholders, and this remains an option for the BBC. Before deciding whether such an approach is appropriate, we consider that we should establish whether the BBC's own procedures and the existing audit arrangements could provide us with the necessary assurance without the need for additional assurance testing.
- 5.64 We note that the BBC is currently reviewing its internal monitoring procedures. We will therefore work with the BBC to understand the nature of this review and the changes that

might follow, as well as the extent to which we can take comfort from its own procedures, including its internal audit function.

- 5.65 Of the BBC's external audits, the Fair Trading Audit appears most relevant, as it provides an opinion on whether the BBC has established and applied a system of internal controls that provide reasonable assurance that the BBC has complied with its 'Fair Trading Arrangements', which include aspects of Ofcom's requirements.
- 5.66 We do not currently have a sufficient understanding of the scope of the work to determine whether the assurance it provides is adequate without the need for further requirements. We therefore intend to work with the BBC's auditors to better understand the scope of their work and the extent to which we can rely on it. In the event that we cannot get sufficient assurance through the existing audits, we will consider options for further assurance work (including for example audit-type opinions or agreed upon procedures).
- 5.67 However, ahead of this work, we consider that the extent to which we can take assurance from the Fair Trading Audit is likely to be limited because the auditors do not report to us. We therefore intend to pursue with the BBC whether changes can be made so that Ofcom can take greater assurance from the Fair Trading Audit.

## Commercial rate of return

- 5.68 As discussed in Section 4, the requirements state that the BBC must:
- a) earn a commercial rate of return on each subsidiary and line of business within it;
  - b) assess what an appropriate commercial rate of return is at the subsidiary and line of business level over an appropriate period of time; and
  - c) take appropriate steps where its subsidiaries are not earning or expected to earn a commercial rate of return.
- 5.69 In the first instance, the requirements put the onus on the BBC to determine what the appropriate rates of return should be. In this section we discuss the reporting requirements which we consider are needed in order to monitor actual performance against what the BBC has assessed as a commercial rate of return.

## Information we need to monitor the requirement

- 5.70 Our guidance makes it clear that the BBC should set its target commercial rates of return for its lines of business with reference to benchmarking where possible. Reviewing the BBC's benchmarking allows us to monitor whether the BBC has assessed what an appropriate rate of return would be. Further, we need to monitor the actual rates of return and how they may differ to the targets that the BBC has set. If the BBC is not expecting to meet its targets, we need to understand how the BBC is going to respond and what steps it will take to ensure that the subsidiary and/or line of business returns to making a commercial rate of return.

## Assessment of information currently available

- 5.71 We have considered the information that is currently available to help us answer the following questions:
- a) How has the BBC assessed what an appropriate commercial rate of return is?
  - b) How does the BBC assess whether the subsidiaries and lines of business are making a commercial rate of return?
  - c) If the subsidiaries and lines of business are not making a commercial rate of return, what steps is the BBC implementing?

### How has the BBC assessed what an appropriate commercial rate of return is?

- 5.72 The BBC is required to provide to Ofcom, annually, the target rate of return it considers appropriate for each line of business. However, this only covers the year ahead. We understand that the BBC may consider the potential returns over a longer period of time than one year, such as three to five years, and as such may have forward looking plans that span several years. We consider that to understand whether a line of business is likely to make a commercial rate of return we need to understand the business plan and how the returns are expected to evolve over time.
- 5.73 Further, the BBC is not required to give us any information regarding why it chose those particular rate of return metrics. For the 2018/19 financial year, the BBC provided explanations behind its choice of metric. This has enabled us to understand better how the BBC has set its targets.
- 5.74 To help assess the appropriate commercial rate of return, we understand that the BBC undertakes a benchmarking exercise of similar entities. For the 2018/19 financial year, the BBC provided to us a high level summary of the benchmarking exercise it used to inform the target rates of return. We currently do not require the BBC to provide this information; however, we believe it will help us to provide context and support for the targets that the BBC has set.

### How does the BBC assess whether the subsidiaries and lines of business are making a commercial rate of return?

- 5.75 The BBC Group accounts provide a high level view of the performance of each of the subsidiaries showing the revenues and costs. Each subsidiary also files its own accounts on Companies House, showing the profit/loss for each financial year.
- 5.76 On 11 July 2018, the BBC published information to comply with the 2017 Requirements as part of its statutory accounts. This covers each subsidiary and provides revenue, cost of sales and operating costs, showing at a high level the profitability of each subsidiary. Where relevant, the accounts also provide the revenue and EBITDA by line of business. The BBC also included commentary regarding the performance of each subsidiary/lines of business.

- 5.77 Each year, the BBC is currently required to provide a “clear description” of each line of business.
- 5.78 Further, each quarter, the BBC is currently required to provide a report to Ofcom on the financial performance of each line of business. This report includes revenue, cost and profit information for each line of business.
- 5.79 Although these sources give us a broad understanding as to how the subsidiary/line of business is performing, they do not provide us with the sufficient detail about the reasons behind the performance trends and changes, nor do they enable us to track actual performance against the expected target throughout the year.

**If the subsidiaries and lines of business are not making a commercial rate of return, what steps is the BBC implementing?**

- 5.80 Neither the published nor confidential information currently available to us gives us any information regarding what the BBC will do or has already done if its commercial subsidiaries or any lines of business within them do not meet their target rates of return.

## **Our proposals**

### **Improving our understanding of the BBC's assessment of the appropriate commercial rates of return**

#### *Target rates of return*

- 5.81 To improve our understanding of the BBC's assessment of the appropriate commercial rate of return, we propose that the BBC must provide the target rates of return for each of its commercial subsidiaries overall. This is in addition to the requirement on the BBC to inform us of its target rates of return for each line of business within each commercial subsidiary.
- 5.82 We also propose that the BBC inform us of the target rates of return it has set for the same period as any business plans it uses for managing its businesses, including the budget for the year ahead which it currently provides. This information over a longer period is important given that it may take time to reach a commercial rate of return.
- 5.83 The BBC should provide the following supporting information:
- a) A clear description of the activities of the commercial subsidiaries and each line of business within them;
  - b) Definition of the metrics (e.g. EBITDA etc) used for assessing the target rates of return and reasons for selecting those metrics. As discussed above, this information was included as part of the BBC's 2018/19 submission so here we propose to include it as a requirement;

- c) A split into relevant categories<sup>105</sup> of the revenues and costs (and assets, liabilities, capital employed and cash flows if applicable) used in the calculation of the target rates of return together with a description of those revenues and costs;
- d) Explanation of how any common costs or overheads have been allocated to each line of business; and
- e) The reasons and evidence on which the BBC has relied on in forming the view that its target rates of return are commercial with reference to market benchmarks, including any internal and external reports on which the BBC has relied on to establish those market benchmarks.

5.84 This will help us better understand how the BBC sets its target rates of return, and the reasons and evidence that supports the BBC's view that these targets are appropriate.

5.85 We consider the above information to be important in our work to ensure that the BBC complies with our requirements for the commercial subsidiaries and the lines of business within them to make a commercial rate of return.

#### **Improving our understanding of the actual rates of return**

5.86 In order to improve our understanding of the actual rates of return achieved by each of the commercial subsidiaries/lines of business we propose the following:

##### *Published financial performance*

5.87 We propose that the published financial performance information must include a description of the activities of each line of business, with the revenues and costs (and assets, liabilities, capital employed and cash flows if applicable) split by key categories with a description of these categories. The BBC must also include an explanation of financial performance.

5.88 We also propose that the BBC demonstrates that the actual rate of return figures that it publishes align with its statutory accounts and the primary statements within those accounts (i.e. the income statement, balance sheet, and the cash flow statement). Since the statutory accounts are audited, this will allow us to have some assurance that the rate of return calculations have been carried out appropriately.

##### *Detailed financial performance (information only provided to Ofcom)*

5.89 We propose to require the BBC to provide to us the budgeted figures, as well as the actuals for the key categories of revenues and costs (and assets, liabilities and cashflow if applicable) underpinning the rate of return calculations, together with the reasons for the differences between actual and budgeted figures. The total revenue and the cost information that we currently receive, without a further breakdown, will not allow us to understand sufficiently any differences between the actual and target rates of return and the reasons for those differences.

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<sup>105</sup> The categories we expect to see here are the ones that the BBC uses for its own reporting and planning purposes.

- 5.90 The BBC must also include a description of the revenues and costs. This must also include an explanation of any differences in cost allocation methods if different to those explained as part of the target setting process.
- 5.91 Separately, we propose that the financial performance information that the BBC provides to us must include a split of the total revenues and costs of each line of business into revenues and costs related to the Public Service, the commercial subsidiaries, other lines of business within the same commercial subsidiary, and third parties.
- 5.92 This information will help us understand the proportion of revenues and costs that are internal (i.e. due to the transactions between the BBC entities) and those that are external (i.e. due to the transactions with the open market). A breakdown of revenues and costs into internal and external amounts will help us understand the relative impact of the BBC's external transactions as opposed to internal transfer charges, on the rate of return calculation.

### **Improving our understanding of the steps taken by the BBC**

#### *Information on target rates of return below commercial level*

- 5.93 If the BBC's targets for any of its commercial subsidiaries or any lines of business within them are below its own assessment of a commercial rate of return, we will need to understand the reasons why and the steps the BBC is planning to take to ensure a commercial rate of return is achieved, the time period over which this is expected to happen, and why the BBC considers this time period to be appropriate.

#### *Information on actual rates of return below target level (included as part of the detailed financial performance information)*

- 5.94 In the event that the actual rate of return achieved by a line of business or a commercial subsidiary is lower than the target rate of return, we propose that the BBC must inform us about the reasons for the shortfall and the steps the BBC is planning to take or has already undertaken to reach the target rate of return in future.

#### *General notification if rates of return below target level*

- 5.95 In addition to the above requirements, if at any other point in time, the BBC identifies that a commercial subsidiary or line of business is not expected to earn a commercial rate of return over an appropriate time period, we propose that the BBC must notify Ofcom and provide an explanation of the steps the BBC is planning to take to address the issue. If the BBC decides to take steps to ensure the commercial subsidiary or the line of business reaches a commercial rate of return, we propose that it must provide information on the period after which a commercial rate of return will be reached and the reasons why it considers this period is appropriate.

## Delivery of information

- 5.96 We do not propose to amend the frequency of the BBC's notification to us of the target rates of return and continue to believe that the annual provision is proportionate given that the BBC only budgets annually.
- 5.97 We do not propose that the target rates of return information be published because it is very likely to be commercially sensitive.
- 5.98 We propose that the published information on financial performance should continue to be published annually. We consider that it is important for stakeholders to have sufficient information on the actual rates of return achieved by the BBC to be able to contribute to our efforts to ensure the BBC complies with our requirements in this area.
- 5.99 We propose to receive detailed financial performance information which is confidential to us biannually; a reduction from quarterly. We consider that we should have a view of how the BBC is performing against targets during the financial year. This will enable us to understand in a timely fashion the measures the BBC is planning to take or has already taken in case it has not met or is not likely to meet its targets.

## Summary of our proposals

- 5.100 The following tables summarise our proposals discussed in this section, including references to the relevant requirement, guidance and templates contained in Annex 1.
- 5.101 With regard to the implementation of our proposals, we propose that our modified reporting requirements must take effect on the date our statement of our decisions relating to this consultation will be published. We expect the modified requirements to take effect for the financial year 2018/19, including the information that is due at the same time as the publication of the BBC's Annual Report and Accounts for the financial year 2018/19 (which is expected to be in July 2019), and the information relating to the target rates of return to be provided prior to the start of the 2019/20 Financial Year.

## Consultation question

Question 5.1 Do you agree with our proposals on the monitoring, reporting and transparency requirements? Please provide reasons and evidence to support your answer.

**Table 5.1 Separate subsidiary and operational separation – summary of revised reporting requirements**

Information required	Contents	Frequency	Deadline	Publication	Reference to Annex 1	Template	Existing or new requirement?
Trading activities revenues	Total revenues from trading activities with third parties split by key categories	Annual	At the same time as the Annual Report and Accounts publication	Yes	D.1	N/A	New requirement
Operational Separation Statement <sup>106</sup>	An Operational Separation Statement setting out how the BBC has complied with the operational separation requirements, including as a minimum, a description of the measures, controls and processes the BBC has in place during that financial year in relation to information sharing, governance arrangements, conflict of interests, information systems, staff co-location arrangements, and training of employees	Annual	At the same time as the Annual Report and Accounts publication	Yes	D.2	N/A	New requirement
Conflicts of interest <sup>107</sup>	Information on all relevant conflicts of interest arising during the Financial Year, including the details of each conflict and the action the BBC has taken to address them	Annual	At the same time as the Annual Report and Accounts publication	No	D.3	N/A	New requirement
Board and executive committee information <sup>108</sup>	Terms of reference and a list of all members sitting on the boards and executive committees of each commercial subsidiary, identification of those who are Public Service employees, and the reporting arrangements between each board and executive committee	Annual and when changes occur	At the same time as the BBC Annual and Accounts Report publication and kept updated to reflect any changes	Yes	D.4	N/A	New requirement

<sup>106</sup> The details for this proposal is discussed in Section 2.

<sup>107</sup> The details for this proposal is discussed in Section 2.

<sup>108</sup> The details for this proposal is discussed in Section 2.

Table 5.2 Supply of goods and services – Summary of revised reporting requirements

Information required	Contents	Frequency	Deadline	Publication	Reference to Annex 1	Template	Existing or new requirement?
Methodology manuals	Methodologies of pricing between the Public Service and the commercial subsidiaries and brand valuation together with methodologies for prices charged by the Public Service to third parties	Annual	At the same time as the Annual Report and Accounts publication	Yes	D.5(a) and D.5(d)	N/A	Existing requirement, new requirement for third parties
Notification of changes to transfer pricing methodologies	Any changes to pricing methodologies including impact assessment and reasons for changes	Biannual	Half year - Three months after the end of the first half of the financial year	No	D.7(a) and D.8	T1	Existing requirement but frequency reduced from quarterly to biannual
			Full year - At the same time as the Annual Report and Accounts publication	Yes	D.5(b)	T1	
Published transfer charges	A breakdown of total transfer charges for the financial year split by key categories as per that in the pricing methodologies manuals, and by the total amounts paid, written off and remaining unpaid	Annual	At the same time as the Annual Report and Accounts publication	Yes	D.5(c)	T2	New requirement
Detailed transfer charges	A breakdown of total transfer charges split by key categories as per that in the pricing methodologies manuals showing actual versus contracted amounts for each key category. Total transfer charges split by the total amounts paid, written off and remaining unpaid, also showing amounts paid and still unpaid re previous years' charges	Biannual	Half year - Three months after the end of the first half of the financial year	No	D.7(b) and D.8	T4	New requirement
			Full year - At the same time as the Annual Report and Accounts publication	No	D.7(b) and D.8	T3	

The BBC's commercial and trading activities – consultation on Ofcom's requirements

Information required	Contents	Frequency	Deadline	Publication	Reference to Annex 1	Template	Existing or new requirement?
Overview of intragroup transactions	Totals of intragroup transactions split by key categories showing how the balances at the end of the financial year are derived from the balances at the start of the financial year, together with explanations and calculations showing how intragroup transactions are treated in preparing the annual consolidated accounts of the BBC Group	Annual	At the same time as the Annual Report and Accounts publication	No	D.6	T5	New requirement

**Table 5.3 Commercial rate of return – Summary of revised reporting requirements**

Information required	Overview of information included	Frequency	Deadline	Publication	Reference to Annex 1	Template	Existing or new requirement?
Target rates of return	Target rates of return for each commercial subsidiary and each line of business within them for the same period as the BBC budgets and business plans, together with a clear description of each line of business, definition of the metrics used and the reasons why, revenues, costs, (assets, liabilities, capital employed and cash flows where relevant) used in the calculation of those rates of return split into key categories with a description, common cost attribution methods, and reasons and evidence for appropriateness of targets	Annual	Before the 1 <sup>st</sup> day of the financial year	No	D.10 and D.11	T6	Existing requirement but further supporting information added
Information on target rates below commercial level	For target rates of return set below the commercial level, the steps planned to reach a commercial rate of return, the period after which a commercial rate of return will be reached and reasons for appropriateness of that period together with supporting business planning and budgeting information	Annual (if applicable)	Before the 1st day of the financial year	No	D.12	No	New requirement
Published financial performance	Financial performance of each commercial subsidiary and each line of business within them, including a clear description of each line of business, rate of return, revenues, costs, (assets, liabilities, capital employed and cash flows where relevant) used in the calculation of the rate of return split into key categories with a description. Demonstration of how these figures reconcile to the statutory	Annual	At the same time as the Annual Report and Accounts publication	Yes	D.9	No	Existing requirement but clarified further

The BBC's commercial and trading activities – consultation on Ofcom's requirements

Information required	Overview of information included	Frequency	Deadline	Publication	Reference to Annex 1	Template	Existing or new requirement?
	accounts of the relevant commercial subsidiary, and providing an explanation of financial performance						
Detailed financial performance	<p>Financial performance of each commercial subsidiary and each line of business within them including rates of return, the revenues, costs, assets, liabilities, capital employed and cash flows in the calculation of those rates of return split into key category with a description, the budgeted figures for the key categories of revenues, costs, assets, liabilities, capital employed and cash flows used in the calculation of those rates of return together with reasons for variances, explanation of cost attribution methods.</p> <p>A split of the revenues and costs used in the calculation of rates of return between the Public Service, other commercial subsidiaries, other lines of business and third parties.</p> <p>If rate of return is below target, the reasons and steps planned to reach target</p>	Biannual	<p>Half year - Three months after the end of the first half of the financial year</p> <p>Full year - At the same time as the Annual Report and Accounts publication</p>	<p>No</p> <p>No</p>	<p>D.13, D.14 and D.15</p> <p>D.13, D.14 and D.15</p>	<p>T7, T8</p> <p>T7, T8</p>	<p>Existing requirement but frequency reduced from quarterly to biannual and further supporting information added</p>
General notification for rate of return below commercial level	<p>In addition to the relevant requirements above, if at any other point in time, the BBC identifies that a commercial subsidiary or a line of business is not expected to earn a commercial rate of return over an appropriate time period, the BBC must provide an explanation of the steps the BBC is planning to take to address the issue.</p> <p>If the BBC decides to take steps to ensure the commercial subsidiary or the line of business reaches a commercial rate of return, it must provide information on the period after which a commercial rate of return will be reached and reasons for appropriateness of that period together with business planning and budgeting information supporting all of the above</p>	When applicable	As soon as practicable	No	D.16	No	Existing requirement but clarified further

# A1. Trading and separation requirements

## Schedule

### Part 1: Definitions and Interpretation

1. In this Schedule -

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

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

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

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

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

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

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

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

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

“Financial Year” means 1 April to 31 March;

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

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

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

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

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

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

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

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

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

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

## Part 2: Requirements and Guidance

### A. Separate subsidiary and operational separation requirements

#### Requirements

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

#### Guidance

##### Exchange of information

- A.6 The relationship between the Public Service and the Commercial Subsidiaries or Joint Ventures creates a risk that the Commercial Subsidiaries and Joint Ventures obtain information which gives them an unfair competitive advantage or distorts the market. The purpose of Requirements A.1 to A.3 is to ensure that this risk is addressed.
- A.7 In order to comply with Requirements A.1 to A.3, we expect the BBC to carry out an ongoing and comprehensive risk assessment to identify areas which present a risk of an unfair

competitive advantage or market distortion, and to implement measures, controls and processes to ensure that information flows are managed as necessary. This risk assessment should be reviewed regularly and include, as a minimum, the following:

- a) an identification of all interfaces between the Public Service and Commercial Subsidiaries and/or Joint Ventures where information is, or could be, shared;
- b) an assessment of what types of commercially sensitive Public Service information, which is not available to third parties, could put the Commercial Subsidiaries and/or Joint Ventures at an unfair competitive advantage or lead to market distortion; and
- c) a determination of whether the information sharing is necessary to ensure that the activities of the Commercial Subsidiaries and/or Joint Ventures fit with the BBC's Mission and Public Purposes or for the fulfilment of a contract.

A.8 Where measures, controls and processes are necessary to manage information flows in accordance with these Requirements, we expect these to include the following:

- a) training of staff and internal guidance;
- b) appropriate arrangements for co-located employees;
- c) IT system controls;
- d) conflicts of interest procedures; and
- e) internal compliance checks of the BBC's risk assessment and the measures, controls and processes in place to manage information sharing risks.

A.9 An example of an area where information sharing could result in an unfair competitive advantage or market distortion is programme commissioning by the Public Service.<sup>2</sup> If BBC Studios has access to commercially sensitive information regarding the commissioning strategies and needs of the Public Service in advance of independent producers, it may be in a better position to prepare and submit tailored ideas and pitches and win commissions. Examples of commercially sensitive information that could raise competition concerns include advance notice of plans to commission large amounts of programmes on a particular theme, and changes to genre strategies or specific decisions in relation to recommissioning of existing programmes. Further examples of areas where information sharing could result in an unfair competitive advantage or market distortion relate to content distribution and sales, and audience research and performance measures.

A.10 Some information may need to be shared to ensure that the Commercial Activities fit with the BBC's Mission and Public Purposes, and this is permitted pursuant to Requirement A.2(a). An example of an area that may fall within this exception is news production. BBC News and BBC Global News may need to share information to ensure that the output of BBC World News<sup>3</sup> fits with the BBC's Mission and Public Purposes, which includes the provision of impartial news and information and reflecting the UK, its culture and values to the world.

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<sup>2</sup> The BBC is also required to comply with the Commissioning Requirements, including the requirement to commission on a fair, reasonable, non-discriminatory and transparent basis.

<sup>3</sup> The commercial news channel that is broadcast outside the UK.

- A.11 Pursuant to Requirement A.2(b), information may be shared if it is necessary for the fulfillment of a contract. For example, this exception would be likely to apply if BBC Studioworks has entered into a contract to provide studio space for live productions produced by the Public Service.
- A.12 As set out in Requirement A.2(c), there may be categories of information that carry no risk of market distortion or an unfair competitive advantage if shared between the Public Service and Commercial Subsidiaries or Joint Ventures. These may include, for example, administrative information associated with shared business support functions, such as payroll administration information.

### **Governance arrangements**

- A.13 The purpose of Requirements A.4 and A.5 is to ensure that the governance of the Commercial Subsidiaries is consistent with an arm's length relationship with the Public Service, and that Commercial Subsidiaries are independent in objective setting, strategy and decision making.<sup>4</sup>
- A.14 It is for the BBC Board to decide how to structure the boards and executive committees of the Commercial Subsidiaries in a way that complies with Requirement A.4. In assessing the BBC's compliance with Requirement A.4, we will focus on:
- a) the balance between non-executive and executive directors;
  - b) whether the chair is independent;
  - c) the extent of overlap in membership between the boards or executive committees of the relevant Commercial Subsidiary and the BBC Board and Public Service executive committees; and
  - d) the degree of influence that the Public Service has on governance and decision making within the relevant Commercial Subsidiary.

### **Reporting requirements for Section A**

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

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<sup>4</sup> The duties of directors of any subsidiary company will be as set out in sections 170 to 177 of the Companies Act 2006, including acting in the interests of the company and avoiding conflicts of interest.

## B. Supply and pricing of goods and services

### Requirements

- B.1 Where the Public Service provides goods and/or services to the Commercial Subsidiaries or Joint Ventures, it must ensure that this takes place at arm's length from the Public Service and on commercial terms.
- B.2 Where the Public Service supplies goods and/or services to third parties, the BBC must not discriminate unduly as to terms<sup>5</sup> and prices:
- a) against third parties when such goods and/or services are supplied to third parties and the Commercial Subsidiaries or Joint Ventures; and
  - b) between different third parties.
- B.3 Subject to the exceptions set out in Requirements B.4 and B.7, the BBC must set prices and terms for goods and/or services supplied by the Public Service to Commercial Subsidiaries, Joint Ventures or third parties on the basis of the following principles:
- a) Set prices and terms for goods and/or services, using an open market process (e.g. competitive tendering), or appropriate market benchmarks.
  - b) In the absence of market information as referred to in Requirement B.3(a), or where it is disproportionate to undertake specific benchmarking exercises, set prices for goods and/or services using cost as a proxy for market prices. The BBC must ensure that such prices:
    - i) cover all relevant direct, long-run costs involved in providing the goods and/or services and include an appropriate contribution to the relevant overheads and capital costs incurred by the business areas together with an appropriate contribution for reinvestment in the Public Service activities; or
    - ii) are only based on the BBC's long-run incremental costs of providing a good and/or service where the BBC can demonstrate that long-run incremental cost pricing conforms to market practice.
  - c) The BBC must not set prices below short-run incremental cost under any circumstances.
- B.4 Requirement B.3 does not apply to business support goods and/or services which the Public Service only shares with the Commercial Subsidiaries. For such business support goods and/or services the BBC may set prices based on long-run costs of provision of those goods and/or services.
- B.5 Where the Commercial Subsidiaries supply goods and/or services to the Public Service, the BBC must set prices and terms for those goods and/or services so as to ensure that they do not exceed market prices or appropriate market benchmarks.
- B.6 The BBC must ensure that:

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<sup>5</sup> All references in the Requirements and Guidance in Section B to "terms" are to be read as "terms and conditions".

- a) any pricing methodologies and terms are reviewed regularly, and consistent approaches are applied to any similar goods and services, including agreements for use of the BBC brands; and
  - b) market benchmarks are relevant, verifiable and reviewed regularly in line with market practice.
- B.7 Requirements B.1 to B.6 inclusive do not apply to pricing of tickets for the events referred to in clause 49(4)(h) of the Agreement (“The Proms, Proms in the Park, Cardiff Singer of the Year, Young Musician of the Year; and other similar events which contribute to the BBC’s Mission and Public Purposes”).

## Guidance

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

- B.8 The primary function of the Public Service is as a broadcaster and it is organised and focused on fulfilling that role. The Public Service sells a range of goods and services to third parties and its Commercial Subsidiaries which may include any Joint Ventures they enter into. This includes licence fee funded content and intellectual property which could be sold to the Commercial Subsidiaries and/or other market participants as well as business support goods and/or services (such as human resources, IT, legal and finance) that are only shared with the Commercial Subsidiaries.
- B.9 It is important to ensure that the prices the Commercial Subsidiaries, Joint Ventures and third parties are charged for these goods and services are set appropriately so that the Commercial Subsidiaries do not gain an unfair competitive advantage.
- B.10 We consider that a “competition on the merits” approach is the relevant starting point for considering how a significant, publicly funded organisation, such as the BBC, should operate with respect to setting prices to both its Commercial Subsidiaries and third parties. This approach allows the Commercial Subsidiaries to benefit from certain legitimate advantages of scale and/or scope enjoyed by the Public Service provided that those advantages are replicable by comparable third parties.
- B.11 Where the Public Service is supplying goods and/or services to its Commercial Subsidiaries or third parties, we consider that the relevant economic concept for the pricing of those goods and/or services is the “opportunity cost” to the Public Service.<sup>6</sup> Given the position of the Public Service in terms of providing inputs to downstream operations, the use of an opportunity cost approach best reflects the operation of an undistorted, competitive market in which firms are acting rationally and not strategically. In other words, we would not expect a rational firm to set prices (for intercompany transfers or otherwise) in such a way as to fulfil strategic aims such as improving the profitability of its commercial subsidiaries. A hypothetical rational commercial rival to the Public Service would not sell a product to its commercial subsidiary or a joint venture it has entered into unless it received a price at least

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<sup>6</sup> The opportunity cost reflects what the Public Service is giving up by choosing to supply a good or service to a particular party.

as high as it could get from supplying a third party. Equally, for products that it would not supply to third parties, it would only supply them to its commercial subsidiaries if the price at least covered the incremental (or avoidable) costs it incurs from providing the product.

#### *Discrimination*

- B.12 The Public Service may supply goods and/or services solely to the Commercial Subsidiaries only if there is a clear reason for exclusivity or where the goods and/or services are being shared for reasons of operational efficiency (such as business support goods and/or services). For instance, we do not expect the BBC to supply such business support goods and/or services to third parties given that the BBC is not “in the business” of supplying such goods and/or services. These goods and/or services are not unique to the Public Service and can and are replicated by other providers.
- B.13 To address the concerns we have about discriminatory access and pricing, where the Public Service supplies goods and/or services to third parties the BBC must not discriminate unduly against or between third parties. However, we recognise that in some cases there may be a fair and objective justification for offering different prices to different parties or refusing to supply goods and/or services to certain parties. For example, there may be cases where supplying to certain third parties could conflict with the BBC's Mission and Public Purposes.

#### *Market-based pricing requirements*

- B.14 We consider that in most cases if the BBC did not supply the good or service to one of its Commercial Subsidiaries or Joint Ventures, it would be likely to supply it to a third party instead. In these instances, the appropriate basis for the transfer price should be the relevant market price or market benchmark. Where the Public Service is already supplying goods and/or services to third parties, we would expect that market prices and/or benchmarks are available and should continue to be used. Where the BBC is starting to supply a good and/or service for the first time, we would expect it to assess the most relevant approach, for example whether to make use of market benchmarks or an open market sale.
- B.15 We set out below a number of examples of different types of goods and services that we would expect to be priced using market prices or benchmarks:
- a) Supply of content / IP for secondary exploitation – the opportunity cost to the Public Service of supplying content / IP to its Commercial Subsidiaries would be the revenue the Public Service could have earned if the good or service had been sold to a third party.
  - b) Licensing of the BBC brand – the BBC brand is one of the most recognisable media brands in the world<sup>7</sup> and its development and maintenance have been funded by the licence fee. The Commercial Subsidiaries use the BBC brand in terms of their corporate names (e.g. BBC Studios) and the goods and services they offer (e.g. BBC Earth). The relevant opportunity cost for the BBC brand would be what a third party might be willing to pay

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<sup>7</sup> It was valued as the 10<sup>th</sup> most valuable media brand in the world – Brand Finance 2018  
[http://brandirectory.com/league\\_tables/table/global-500-2018](http://brandirectory.com/league_tables/table/global-500-2018).

to use it, taking into account any restrictions the Public Service might reasonably impose to protect the reputation and value of the BBC brand.

- B.16 One way of determining market prices is to put the good or service out to tender. If one of the Commercial Subsidiaries was successful at winning the tender, it would demonstrate that that Commercial Subsidiary placed the most value on the good or service in question. The Public Service would then earn the highest possible revenue and there would be no concern about discrimination or that the Commercial Subsidiary received an unfair competitive advantage.
- B.17 An open market process may also be an important input into establishing relevant market benchmarks for use in the transfer pricing of other goods and services as previous actual sales to third parties would be considered a legitimate source of benchmarking data.
- B.18 However, we also recognise that it is not always practicable to tender goods and/or services. Another way of determining market prices is for the BBC to establish what a market price would be through benchmarking of suitable comparators. When using benchmarks to set prices, the BBC should consider how representative the benchmark is in relation to the good or service in question and how recently that benchmarking analysis was undertaken. We would expect the BBC to be able to show that it had gathered relevant, verifiable and comparable evidence on prevailing market practices (including both prices and terms) for the benchmarks it has used. This could include publicly available sources (e.g. published rate cards<sup>8</sup>), benchmarking studies or independent experts. We recognise that the relevant market rate for a given activity may vary depending on the nature of the arrangement in question. For example, prices for studio capacity booked at short notice may differ from prices for capacity booked well in advance.
- B.19 The BBC should ensure that its benchmarks are reviewed regularly in line with market practice and be able to demonstrate the data is up to date and takes into account the nature and duration of the underlying contractual arrangements.
- B.20 It may not be possible for the BBC to determine an absolute market benchmark for some of its goods and/or services – for example, if there was a range of benchmark products that were imperfect substitutes. In these circumstances, it is likely that there would be a range of prices within the benchmark and the relevant price should lie within this range.
- B.21 With respect to the licensing of the BBC brand, we recognise that determining a price might be difficult. However, we note that the BBC currently charges its Commercial Subsidiaries for the use of its brand as a proportion of the revenues that are directly linked to its use. We consider this may be a reasonable proxy for the value of the BBC brand.
- B.22 The Requirements also allow for prices to be set based on costs in some rare cases where the Public Service is unable to identify appropriate, reliable benchmarking data or where it may not be proportionate to undertake benchmarking, for example for immaterial, one off

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<sup>8</sup> An example of where a rate-card may be used is for hiring a studio. We recognise that published rate-cards may not always be an accurate representation of actual prices paid for goods and/or services. That is, the rate-card may only serve as a starting point for commercial negotiations over price.

transactions. In these instances, we would expect that the long-run cost is a proxy for the market price and, as such, includes a mark-up on costs.

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

#### *Shared business support services pricing requirements*

- B.24 Where the Public Service is only sharing, and is only ever likely to share, goods and/or services with its Commercial Subsidiaries, then the opportunity cost is the long-run costs of provision to the Public Service. That is, the alternative would be for the Public Service to scale back or discontinue provision (rather than offer the good or service to third parties). This should be the case in the specific situations where the Public Service is sharing business support goods and/or services with the Commercial Subsidiaries.
- B.25 The opportunity cost to the Public Service of these business support functions would be based on the long-run incremental costs of provision of these goods and/or services to its Commercial Subsidiaries. In this situation, cost-based prices could be derived from either:
- a) the long-run incremental costs incurred by the Public Service in providing these goods and/or services; or
  - b) the long-run costs avoided if the Public Service no longer provided the goods and/or services to the Commercial Subsidiaries.
- B.26 We expect that these two approaches would have equivalent outcomes. However, we recognise that in practice it may not be possible to set transfer prices on a pure, long-run incremental cost basis or that it may not be proportionate to do so. For example, reliable data may not be available on the level of the long-run incremental costs. In these cases, fully allocated costs may be a reasonable proxy for long-run incremental costs.
- B.27 Where the BBC has procured a contract on behalf of the entire BBC Group, it is important to ensure that at a minimum an appropriate increment of the contract cost is charged to the Commercial Subsidiaries.
- B.28 Given our competition concerns are in relation to the Commercial Subsidiaries gaining an unfair competitive advantage, the BBC can set transfer prices for goods and services supplied to the Commercial Subsidiaries that are higher than the market price or cost (depending on the methodology used), if it wishes to do so.

#### **Supply by Commercial Subsidiaries to the Public Service**

- B.29 There are a number of instances where the Commercial Subsidiaries supply goods and services to the Public Service. This includes studio capacity, post production facilities and new content. Where this is the case our main competition concern is that the Public Service

could use its special funding position to pay inflated prices for goods and/or services supplied by its Commercial Subsidiaries and so confer an unfair advantage on them by boosting their revenues and overall rates of return.

- B.30 The guidance set out above in relation to market prices and benchmarks also applies when determining how much the Public Service should pay for goods and/or services supplied by the Commercial Subsidiaries. In particular, if market benchmarks are used, they should be relevant, verifiable and regularly reviewed.
- B.31 Requirement B.5 does not apply to the supply of original programming and content by BBC Studios to the Public Service through the commissioning process, which is subject to the Commissioning Requirements.

#### **Exception for ticket sales**

- B.32 We note that clause 49(4)(h) of the Agreement envisages the BBC recovering a contribution to the costs of staging certain events from the proceeds of ticket sales in accordance with a statement of policy that is agreed with the Secretary of State. The events are "The Proms, Proms in the Park, Cardiff Singer of the Year, Young Musician of the Year; and any other similar events which contribute to the BBC's Mission and Public Purposes". In recognition of this, our 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.

#### **Reporting requirements for Section B**

- B.33 We also gather information on how the BBC is complying with Requirements B.1 to B.7 inclusive through separate monitoring, reporting and transparency requirements. These are set out in Section D of the Requirements, Requirements D.5 to D.8.

## C. Commercial rate of return

### Requirements

- C.1 The BBC must, over an appropriate period of time, earn a commercial rate of return on its Commercial Activities:
- a) at the Commercial Subsidiary level; and
  - b) at the line of business level.
- C.2 The BBC must assess and set an appropriate commercial rate of return for each of the activities referred to in Requirements C.1(a) and C.1(b).
- C.3 Where the BBC considers that one or more of the activities referred to in Requirements C.1(a) and C.1(b) are not likely to earn a commercial rate of return over an appropriate period of time, the BBC must, as soon as practicable, conduct a performance review. Following that review the BBC must implement any necessary steps, including a revised business plan, to enable the activities in question to earn a commercial rate of return over that period of time.
- C.4 For the purposes of Requirements C.1 to C.3, the BBC must:
- a) set appropriate lines of business; and
  - b) inform Ofcom as soon as practicable where it proposes to make any changes to any of its lines of business.

### Guidance

#### Appropriate commercial rate of return

- C.5 Requirements C.1 to C.4 inclusive help to:
- a) ensure that BBC public funding is not used to finance loss making Commercial Activities; and
  - b) reinforce the principle that Commercial Activities are undertaken on an arm's length basis and in accordance with normal market principles.
- C.6 A key aspect of the return earned by a Commercial Activity will be the price the Commercial Subsidiary or the line of business in question has paid for its inputs. We do not focus on the rate of return in isolation and in each case, we will usually consider a Commercial Activity's rate of return in combination with transfer pricing to assess whether the relationship between the Public Service and a Commercial Activity has had an unfair competitive advantage or a market distorting effect. We also consider that it would not be appropriate to focus on a specific measure of rate of return but rather to use the rate of return metric that is most relevant to the market or line of business in question.<sup>9</sup>

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<sup>9</sup> For example, rates of return can be measured in terms of: return on capital employed; return on sales; return on investment etc.

- C.7 The BBC is required to assess what an appropriate commercial rate of return is for Commercial Activities at the Commercial Subsidiary level and the line of business level. However, the BBC is not required to carry out such an analysis at the level of individual goods and/or services or specific activities (e.g. individual book titles).
- C.8 In assessing whether the commercial rate of return of a Commercial Subsidiary and each line of business within that Commercial Subsidiary is appropriate, we would consider, amongst other things, whether a rational private investor would invest in that Commercial Subsidiary and/or that line of business.
- C.9 In using this approach, it is important to recognise:
- a) A Commercial Subsidiary and/or line of business need not generate a profit every year, particularly if it is a new activity. For example, a business plan may project a loss in the early years of a new activity as the business grows. However, the plan must forecast that it will achieve a commercial rate of return over an appropriate period of time;
  - b) Requirement C.1 provides that Commercial Activities at the Commercial Subsidiary level and at the line of business level must earn a commercial rate of return over an appropriate time period. However, in some circumstances an investment in one line of business could generate indirect returns elsewhere, and a rational investor may accept low returns on a specific investment if this investment produces high returns for the same investor from other assets. Where this is the case we would expect the BBC to be able to demonstrate how low returns on one line of business supported higher returns elsewhere in order to show that the low returns nevertheless represent appropriate commercial rates of return; and
  - c) The actual (ex-post) return could be very different (higher or lower) than the estimated return at the time the investment is made.
- C.10 What constitutes a commercial rate of return will depend on the specific market circumstances and the Requirements do not specify rates of return. Instead, the BBC must monitor and research the markets in which Commercial Subsidiaries and the lines of business operate (including using benchmark rates of return) to ensure that the returns generated by their Commercial Activities are in line with commercial rates of return.
- C.11 Given that Commercial Activities must be separate from the delivery of the Public Purposes and are only required to fit with the BBC's Mission and Public Purposes, a non-commercial rate of return cannot be justified on the grounds of assisting the delivery of the BBC's Mission and Public Purposes. However, in considering whether to (i) investigate a potential breach of Requirements C.1 to C.4, and (ii) impose a penalty in the event that a breach is found, we will take into consideration, among other factors set out in our Enforcement Procedures,<sup>10</sup> any link between the Commercial Activity in question and the other activities carried out by

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<sup>10</sup> Statement on Procedures for enforcement of BBC competition requirements which is available at: [https://www.ofcom.org.uk/\\_\\_data/assets/pdf\\_file/0011/102521/Statement-on-Procedures-for-enforcement-of-BBC-competition-requirements.pdf](https://www.ofcom.org.uk/__data/assets/pdf_file/0011/102521/Statement-on-Procedures-for-enforcement-of-BBC-competition-requirements.pdf)

the BBC which are subject to the regulatory regimes established by the Operating Framework.

- C.12 The BBC may of course set additional rate of return benchmarks either for its own internal investment appraisal purposes or in terms of setting performance targets for existing Commercial 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.

#### **Suspected failure to achieve an appropriate commercial rate of return**

- C.13 We recognise that there may be situations where returns are low, particularly in the short term. For example, unexpected changes to market or economic conditions may cause performance to deviate from expectations.
- C.14 However, if the BBC considers that an activity is not likely to earn a commercial rate of return over an appropriate period of time, under Requirement C.3 the BBC is obliged to follow the specified process and take remedial steps. In reviewing performance and implementing any necessary steps to move to earning a commercial rate of return, the BBC must decide whether the line of business should be modified, scaled back, stopped, or divested.
- C.15 Where we are concerned that the BBC has not complied with one or more of Requirements C.1 to C.4, we will consider whether to launch an investigation. If, following such an investigation, we find that the BBC has failed to comply with the Requirements, we may direct the BBC to take action to ensure that the Commercial Subsidiary and/or the line of business earn an appropriate commercial rate of return within an appropriate time period or do anything else we consider appropriate to remedy the breach. In considering whether to open an investigation and whether to impose a penalty in the event that a breach is found, we will take into account, among other factors set out in the Enforcement Procedures, the extent of any risk of market distortion, or the Commercial Activity in question gaining an unfair competitive advantage, as a result of its relationship with the Public Service.
- C.16 For the avoidance of doubt, where a Commercial Subsidiary has entered into a Joint Venture, the Commercial Subsidiary's share of revenues and costs associated with this Joint Venture must be included in the relevant lines of business.

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

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

## D. Monitoring, reporting and transparency

### Requirements

#### Separate subsidiary and operational separation

- D.1 The BBC must publish, each Financial Year at the same time as the BBC Annual Report is published for that Financial Year, total revenues of the Trading Activities with third parties which have been carried out by the Public Service. The total revenues of the Trading Activities must be split by key categories including, as a minimum, rental income and royalties' income.
- D.2 The BBC must publish, each Financial Year at the same time as the BBC Annual Report is published for that Financial Year, an Operational Separation Statement setting out how the BBC has complied with Requirements A.1 to A.5 inclusive during that Financial Year. Each Operational Separation Statement must include as a minimum the following:
- a) an overview of the processes the BBC has adopted in identifying areas of risk for information sharing;
  - b) a description of all measures, controls and processes implemented to ensure compliance with Requirements A.1 to A.5 inclusive, including any relevant internal codes or policies;
  - c) an account of how the governance of the Commercial Subsidiaries reflects Requirements A.1 to A.5 inclusive;
  - d) an explanation of any issues with the effectiveness of the BBC's controls during the previous Financial Year and what steps the BBC has taken to improve their effectiveness;
  - e) a description of the relevant measures, controls and processes in the following areas:
    - i) information sharing;
    - ii) governance arrangements;
    - iii) conflicts of interest;
    - iv) IT systems;
    - v) appropriate arrangements for co-located employees, including controls applicable if employees of the Public Service and one or more of the Commercial Subsidiaries or Joint Ventures share the same building(s); and
    - vi) training of the employees of the BBC and internal guidance on ensuring the BBC's compliance with Requirements A.1 to A.5 inclusive.
- D.3 The BBC must inform Ofcom, each Financial Year at the same time as the BBC Annual Report is published for that Financial Year, of all conflicts of interest identified pursuant to Requirement A.5 during that Financial Year, including the details of each conflict and the action the BBC has taken to address each conflict.
- D.4 For each board and executive committee governing Commercial Subsidiaries, the BBC must publish each Financial Year at the same time as the BBC Annual Report is published for that

Financial Year, and keep updated on an ongoing basis in a prominent place on the relevant publicly available website operated or controlled by the BBC, the following:

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

### Supply and pricing of goods and services

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

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

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

- a) totals of all the transactions conducted in that Financial Year between the Public Service and each Commercial Subsidiary split by key categories showing how the balances at the

end of the Financial Year have been derived from the balances which were in place at the start of the Financial Year; the key categories of transactions conducted between the Public Service and each Commercial Subsidiary must include, as a minimum, total Transfer Charges, dividends and loans; and

- b) explanations and calculations showing how the transactions referred to in Requirement D.6(a) are treated in preparing the consolidated balance sheet and income statement of the BBC Group for the Financial Year.

D.7 The BBC must provide to Ofcom:

- a) any changes that the BBC has made since the most recent publication pursuant to Requirement D.5(b) to any of its methodologies for calculating Transfer Prices and prices referred to in Requirements D.5(a)(i) to D.5(a)(iii) inclusive, including:
  - i) an explanation of the reasons for those changes; and
  - ii) a statement of the impact of those changes; and
- b) a breakdown of total Transfer Charges charged by the Public Service to each Commercial Subsidiary; and each Commercial Subsidiary to the Public Service, each breakdown split by:
  - i) the key categories used in the Pricing Methodology Manuals, which as a minimum must include property, human resources, business affairs, finance, legal and procurement;
  - ii) for each key category, the amounts charged in the first half of the Financial Year and the whole of that Financial Year compared with the Contracted Amounts for the first half of the Financial Year and the whole of that Financial Year respectively (as applicable);
  - iii) the total amounts that were paid or written off during the first half of the Financial Year and the whole of that Financial Year (as applicable), or remained unpaid as at the end of the first half of the Financial Year and at the end of that Financial Year (as applicable); and
  - iv) the total amounts that were paid or written off in that Financial Year in relation to previous Financial Years' Transfer Charges, and the amounts that remained unpaid as at the end of the Financial Year from previous Financial Years' charges.

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

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

### **Commercial rate of return**

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

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

*Provision of Target Rates of Return information to Ofcom*

- D.10 The BBC must provide to Ofcom no later than the first day of each Financial Year the Target Rates of Return the BBC considers appropriate for each Commercial Subsidiary and each line of business within that Commercial Subsidiary, setting out in each case:
- a) a clear description of the activities carried out by each Commercial Subsidiary and each line of business within that Commercial Subsidiary;
  - b) a definition of the metrics used for assessing those Target Rates of Return and reasons for selecting those metrics;
  - c) the revenues, costs, assets, liabilities, capital employed and cash flows used in the calculation of those rates of return, split into key categories together with a description of those key categories;
  - d) explanations of cost attribution methods applied to common costs in the calculation of those Target Rates of Return; and
  - e) reasons and evidence that the BBC has used in forming its view on whether each of those Target Rates of Return is appropriate, including all information concerning market benchmarks and/or reports prepared by the BBC and/or third parties for the BBC.
- D.11 The information required under Requirement D.10 must be provided for all the future Financial Years included in the period for which the BBC has prepared its budgets and/or business plans.
- D.12 In the event that the Target Rates of Return for any Commercial Subsidiary or any line of business within a Commercial Subsidiary fall below the BBC's assessment of the commercial

rate of return, the BBC must provide to Ofcom as soon as practicable the following information:

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

*Provision of achieved rates of return information to Ofcom*

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

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

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

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

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

- a) the reasons for the difference between the target rate of return and the achieved rate of return; and

- b) explanation of the steps that the BBC has already taken, and/or is intending to take, in order to achieve the target rate of return.

*Other requirements*

- D.16 In addition to Requirements D.12 and D.15, if at any other point in time the BBC identifies that a Commercial Subsidiary and/or a line of business within a Commercial Subsidiary is not expected to earn a commercial rate of return over an appropriate period of time, the BBC must provide to Ofcom as soon as practicable the following information:
- a) explanation of the steps the BBC is planning to take in relation to the Commercial Subsidiary and/or the line or business in question;
  - b) if the BBC decides to take steps to ensure the Commercial Subsidiary and/or the line of business in question reaches a commercial rate of return, the period of time after which the BBC expects that that commercial rate of return will be reached and the reasons why the BBC considers that period of time to be appropriate; and
  - c) any business planning and budgeting information necessary to support the information provided under D.16(a) and (b).

*General*

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

adequate explanation of the information published and provided to Ofcom (as applicable) pursuant to Requirements D.1 to D.16.

## Guidance

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

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

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

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

### Reporting of commercial rate of return information

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

## Part 3: Reporting templates

<b>TEMPLATE 1</b>					
<b>Requirements D.5(b) and D.7(a)</b>					
<b>Notification of Pricing Methodology Manuals - Impact assessment</b>					
Commercial Subsidiary: ...					
First half of financial year ended / financial year ended: ...					
Goods and services	Total Transfer Charge for financial period/year after the methodological changes have been applied	Less impact of change 1	Less impact of change 2	...	Total Transfer Charge for financial period/year if the methodological changes had not been applied
	£m	£m	£m	£m	£m
Key category 1	x	x	x	x	x
Key category 2	x	x	x	x	x
Key category 3	x	x	x	x	x
...	x	x	x	x	x
<b>Total</b>	<b>x</b>	<b>x</b>	<b>x</b>	<b>x</b>	<b>x</b>
<b>Notes</b>					
The schedule for the Financial Year must include all the changes made during the Financial Year (including the first half of the Financial Year).					

<b>TEMPLATE 2</b>	
<b>Requirement D.5(c)</b>	
<b>Summary of total Transfer Charges</b>	
<b>Charged by Public Service to Commercial Subsidiary ... / Charged by Commercial Subsidiary ... to Public Service</b>	
<b>Financial Year ended: ...</b>	
Goods and/or services	£m
Key category 1	x
Key category 2	x
Key category 3	x
...	x
<b>Total</b>	<u><u>x</u></u>
Paid in Financial Year	x
Unpaid at end of Financial Year	x
Written off in Financial Year	x
<b>Total</b>	<u><u>x</u></u>

<b>TEMPLATE 3</b>			
<b>Requirements D.7(b)</b>			
<b>Summary of total Transfer Charges</b>			
<b>Charged by Public Service to Commercial Subsidiary ... / Charged by Commercial Subsidiary ... to Public Service</b>			
<b>Financial year ended: ...</b>			
Goods and/or services	Total actual Transfer Charge for Financial Year	Total contracted Transfer Charge for Financial Year	Variance between total Transfer Charge and total contracted Transfer Charge for Financial Year
	£m	£m	£m
Key category 1	x	x	x
Key category 2	x	x	x
Key category 3	x	x	x
...	x	x	x
<b>Total</b>	<u>x</u>	<u>x</u>	<u>x</u>
<b>Total Transfer Charge for Financial Year:</b>			
Paid in Financial Year	x		
Unpaid at end of Financial Year	x		
Written off in Financial Year	x		
<b>Total</b>	<u>x</u>		
<b>Total Transfer Charge for previous Financial Years:</b>			
Paid in this Financial Year	x		
Unpaid at end of this Financial Year	x		
Written off in this Financial Year	x		
<b>Total</b>	<u>x</u>		

<b>TEMPLATE 4</b>			
<b>Requirements D.7(b)</b>			
<b>Summary of total Transfer Charges</b>			
<b>Charged by Public Service to Commercial Subsidiary ... / Charged by Commercial Subsidiary ... to Public Service</b>			
<b>First half of Financial Year ended: ...</b>			
Goods and/or services	Total actual Transfer Charge for first half of Financial Year	Total contracted Transfer Charge for first half of Financial Year	Variance between total Transfer Charge and total contracted Transfer Charge for first half of Financial Year
	£m	£m	£m
Key category 1	x	x	x
Key category 2	x	x	x
Key category 3	x	x	x
...	x	x	x
<b>Total</b>	<u>x</u>	<u>x</u>	<u>x</u>
<b>Total transfer charge for first half of financial year:</b>			
Paid in Financial Year	x		
Unpaid at end of Financial Year	x		
Written off in Financial Year	x		
<b>Total</b>	<u>x</u>		
<b>Total Transfer Charge for previous Financial Years:</b>			
Paid in first half of this Financial Year	x		
Unpaid at end of the first half of this Financial Year	x		
Written off in the first half of this Financial Year	x		
<b>Total</b>	<u>x</u>		

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TEMPLATE 5													
Requirement D.6													
Summary of transactions between Public Service and Commercial Subsidiaries													
Financial Year ended: ...													
Commercial Subsidiary	Balance as at start of Financial Year	Total Transfer Charges for goods and service supplied by the Public Service	Total amounts paid in relation to Transfer Charges for goods and service supplied by the Public Service	Total Transfer Charges for goods and service supplied by the Public Service written off	Total Transfer Charges for goods and service supplied to the Public Service	Total amounts paid in relation to Transfer Charges for goods and service supplied to the Public Service	Total Transfer Charges for goods and service supplied to the Public Service written off	Dividends declared	Dividends paid	Loan proceeds received	Loan repayments	Other	Balance as at end of Financial Year
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Commerical Subsidiary 1	x	x	x	x	x	x	x	x	x	x	x	x	x
Commerical Subsidiary 2	x	x	x	x	x	x	x	x	x	x	x	x	x
Commerical Subsidiary 3	x	x	x	x	x	x	x	x	x	x	x	x	x
...	x	x	x	x	x	x	x	x	x	x	x	x	x
<b>Total</b>	<b>x</b>	<b>x</b>	<b>x</b>	<b>x</b>	<b>x</b>	<b>x</b>	<b>x</b>	<b>x</b>	<b>x</b>	<b>x</b>	<b>x</b>	<b>x</b>	<b>x</b>

<b>TEMPLATE 6</b>									
<b>Requirements D.10 and D.11</b>									
<b>Target Rate of Return calculation</b>									
Financial Year ending: ...									
	Commercial Subsidiary 1				Commercial Subsidiary 2				...
	Line of business 1	Line of business 2	...	Total	Line of business 1	Line of business 2	...	Total	
	£m	£m	£m	£m	£m	£m	£m	£m	
<u>Revenues</u>									
Revenue stream 1	x	x	x	x	x	x	x	x	...
Revenue stream 2	x	x	x	x	x	x	x	x	...
Revenue stream 3	x	x	x	x	x	x	x	x	...
...	x	x	x	x	x	x	x	x	...
	x	x	x	x	x	x	x	x	...
<u>Direct costs</u>									
Direct cost category 1	x	x	x	x	x	x	x	x	...
Direct cost category 2	x	x	x	x	x	x	x	x	...
Direct cost category 3	x	x	x	x	x	x	x	x	...
...	x	x	x	x	x	x	x	x	...
	x	x	x	x	x	x	x	x	...
<u>Common costs allocated</u>									
Common cost category 1	x	x	x	x	x	x	x	x	...
Common cost category 2	x	x	x	x	x	x	x	x	...
Common cost category 3	x	x	x	x	x	x	x	x	...
...	x	x	x	x	x	x	x	x	...
	x	x	x	x	x	x	x	x	...
<u>Common costs not allocated</u>									
Common cost category 1				x				x	...
Common cost category 2				x				x	...
Common cost category 3				x				x	...
...				x				x	...
				x				x	...
Return	x	x	x	x	x	x	x	x	...
Target Rate of Return%	x	x	x	x	x	x	x	x	...

**Notes**  
We set out this template for the reporting of (i) Target Rate of Return using a return on sales approach, and (ii) the return figures used in any other approach such as return on assets or capital employed.

<b>TEMPLATE 7</b>				
<b>Requirements D.13</b>				
<b>Financial performance of Commercial Subsidiaries - lines of business</b>				
Commercial Subsidiary: ...				
First half of Financial Year ended / Financial Year ended: ...				
	Line of business 1	Line of business 2	...	Total
	£m	£m	£m	£m
<u>Revenues</u>				
Third parties	x	x	x	x
Public Service	x	x	x	x
Other Commercial Subsidiaries	x	x	x	x
Other lines of business within the Commercial Subsidiary	x	x	x	x
	x	x	x	x
<u>Direct costs</u>				
Third parties	x	x	x	x
Public Service	x	x	x	x
Other Commercial Subsidiaries	x	x	x	x
Other lines of business within the Commercial Subsidiary	x	x	x	x
	x	x	x	x
<u>Common costs allocated</u>				
Third parties	x	x	x	x
Public Service	x	x	x	x
Other Commercial Subsidiaries	x	x	x	x
Other lines of business within the Commercial Subsidiary	x	x	x	x
	x	x	x	x
<u>Common costs not allocated</u>				
Third parties				x
Public Service				x
Other Commercial Subsidiaries				x
Other lines of business within the Commercial Subsidiary				x
				x
Return	x	x	x	x
Rate of return %	x	x	x	x

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TEMPLATE 8														
Requirement D.13														
Financial performance of Commercial Subsidiaries - Lines of business														
Commercial Subsidiary: ...														
First half of Financial Year ended / Financial Year ended: ...														
	Actual				Budget				Variance				Reasons for variance	
	Line of business 1	Line of business 2	...	Total	Line of business 1	Line of business 2	...	Total	Line of business 1	Line of business 2	...	Total		
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	
<u>Revenues</u>														
Revenue stream 1	x	x	x	x	x	x	x	x	x	x	x	x	x	...
Revenue stream 2	x	x	x	x	x	x	x	x	x	x	x	x	x	...
Revenue stream 3	x	x	x	x	x	x	x	x	x	x	x	x	x	...
...	x	x	x	x	x	x	x	x	x	x	x	x	x	...
	x	x	x	x	x	x	x	x	x	x	x	x	x	...
<u>Direct costs</u>														
Direct cost category 1	x	x	x	x	x	x	x	x	x	x	x	x	x	...
Direct cost category 2	x	x	x	x	x	x	x	x	x	x	x	x	x	...
Direct cost category 3	x	x	x	x	x	x	x	x	x	x	x	x	x	...
...	x	x	x	x	x	x	x	x	x	x	x	x	x	...
	x	x	x	x	x	x	x	x	x	x	x	x	x	...
<u>Common costs allocated</u>														
Common cost category 1	x	x	x	x	x	x	x	x	x	x	x	x	x	...
Common cost category 2	x	x	x	x	x	x	x	x	x	x	x	x	x	...
Common cost category 3	x	x	x	x	x	x	x	x	x	x	x	x	x	...
...	x	x	x	x	x	x	x	x	x	x	x	x	x	...
	x	x	x	x	x	x	x	x	x	x	x	x	x	...
<u>Common costs not allocated</u>														
Common cost category 1				x				x					x	...
Common cost category 2				x				x					x	...
Common cost category 3				x				x					x	...
...				x				x					x	...
				x				x					x	...
Return	x	x	x	x	x	x	x	x	x	x	x	x	x	...
Rate of return %	x	x	x	x	x	x	x	x	x	x	x	x	x	...
<u>Notes</u>														
The returns and rates of return included under the 'Budget' columns must represent the target returns and rates of return.														
We set out this template for the reporting of (i) Target Rate of Return using a return on sales approach, and (ii) the return figures used in any other approach such as return on assets or capital employed.														

## A3. Responding to this consultation

### How to respond

- A3.1 Ofcom would like to receive views and comments on the issues raised in this document, by 5pm on 24 September 2018.
- A3.2 You can download a response form from <https://www.ofcom.org.uk/consultations-and-statements/category-2/bbc-commercial-trading-activities>. You can return this by email or post to the address provided in the response form.
- A3.3 If your response is a large file, or has supporting charts, tables or other data, please email it to [melanie.everitt@ofcom.org.uk](mailto:melanie.everitt@ofcom.org.uk), as an attachment in Microsoft Word format, together with the cover sheet (<https://www.ofcom.org.uk/consultations-and-statements/consultation-response-coversheet>).
- A3.4 Responses may alternatively be posted to the address below, marked with the title of the consultation:  
Melanie Everitt  
Ofcom  
Riverside House  
2A Southwark Bridge Road  
London SE1 9HA
- A3.5 We welcome responses in formats other than print, for example an audio recording or a British Sign Language video. To respond in BSL:
- a) Send us a recording of you signing your response. This should be no longer than 5 minutes. Suitable file formats are DVDs, wmv or QuickTime files. Or
  - b) Upload a video of you signing your response directly to YouTube (or another hosting site) and send us the link.
- A3.6 We will publish a transcript of any audio or video responses we receive (unless your response is confidential).
- A3.7 We do not need a paper copy of your response as well as an electronic version. We will acknowledge receipt if your response is submitted via the online web form, but not otherwise.
- A3.8 You do not have to answer all the questions in the consultation if you do not have a view; a short response on just one point is fine. We also welcome joint responses.
- A3.9 It would be helpful if your response could include direct answers to the questions asked in the consultation document. The questions are listed at Annex 6. It would also help if you could explain why you hold your views, and what you think the effect of Ofcom's proposals would be.
- A3.10 If you want to discuss the issues and questions raised in this consultation, please contact Melanie Everitt by email to [melanie.everitt@ofcom.org.uk](mailto:melanie.everitt@ofcom.org.uk).

## Confidentiality

- A3.11 Consultations are more effective if we publish the responses before the consultation period closes. In particular, this can help people and organisations with limited resources or familiarity with the issues to respond in a more informed way. So, in the interests of transparency and good regulatory practice, and because we believe it is important that everyone who is interested in an issue can see other respondents' views, we usually publish all responses on our website, [www.ofcom.org.uk](http://www.ofcom.org.uk), as soon as we receive them.
- A3.12 If you think your response should be kept confidential, please specify which part(s) this applies to, and explain why. Please send any confidential sections as a separate annex. If you want your name, address, other contact details or job title to remain confidential, please provide them only in the cover sheet, so that we don't have to edit your response.
- A3.13 If someone asks us to keep part or all of a response confidential, we will treat this request seriously and try to respect it. But sometimes we will need to publish all responses, including those that are marked as confidential, in order to meet legal obligations.
- A3.14 Please also note that copyright and all other intellectual property in responses will be assumed to be licensed to Ofcom to use. Ofcom's intellectual property rights are explained further at <https://www.ofcom.org.uk/about-ofcom/website/terms-of-use>.

## Next steps

- A3.15 Following this consultation period, Ofcom plans to publish a statement by the end of 2018.
- A3.16 If you wish, you can register to receive mail updates alerting you to new Ofcom publications; for more details please see <https://www.ofcom.org.uk/about-ofcom/latest/email-updates>.

## Ofcom's consultation processes

- A3.17 Ofcom aims to make responding to a consultation as easy as possible. For more information, please see our consultation principles in Annex 4.
- A3.18 If you have any comments or suggestions on how we manage our consultations, please email us at [consult@ofcom.org.uk](mailto:consult@ofcom.org.uk). We particularly welcome ideas on how Ofcom could more effectively seek the views of groups or individuals, such as small businesses and residential consumers, who are less likely to give their opinions through a formal consultation.
- A3.19 If you would like to discuss these issues, or Ofcom's consultation processes more generally, please contact Ofcom's consultation champion:

Corporation Secretary

Ofcom

Riverside House

2a Southwark Bridge Road

London SE1 9HA

Email: [corporationsecretary@ofcom.org.uk](mailto:corporationsecretary@ofcom.org.uk)

## A4. Ofcom's consultation principles

### Ofcom has seven principles that it follows for every public written consultation:

#### Before the consultation

- A4.1 Wherever possible, we will hold informal talks with people and organisations before announcing a big consultation, to find out whether we are thinking along the right lines. If we do not have enough time to do this, we will hold an open meeting to explain our proposals, shortly after announcing the consultation.

#### During the consultation

- A4.2 We will be clear about whom we are consulting, why, on what questions and for how long.
- A4.3 We will make the consultation document as short and simple as possible, with a summary of no more than two pages. We will try to make it as easy as possible for people to give us a written response. If the consultation is complicated, we may provide a short Plain English / Cymraeg Clir guide, to help smaller organisations or individuals who would not otherwise be able to spare the time to share their views.
- A4.4 We will consult for up to ten weeks, depending on the potential impact of our proposals.
- A4.5 A person within Ofcom will be in charge of making sure we follow our own guidelines and aim to reach the largest possible number of people and organisations who may be interested in the outcome of our decisions. Ofcom's Consultation Champion is the main person to contact if you have views on the way we run our consultations.
- A4.6 If we are not able to follow any of these seven principles, we will explain why.

#### After the consultation

- A4.7 We think it is important that everyone who is interested in an issue can see other people's views, so we usually publish all the responses on our website as soon as we receive them. After the consultation we will make our decisions and publish a statement explaining what we are going to do, and why, showing how respondents' views helped to shape these decisions.

## A5. Consultation coversheet

### BASIC DETAILS

Consultation title: organisation realise

To (Ofcom contact):

Name of respondent:

Representing (self or organisation/s):

Address (if not received by email):

### CONFIDENTIALITY

Please tick below what part of your response you consider is confidential, giving your reasons why

Nothing

Name/contact details/job title

Whole response

Organisation

Part of the response

If there is no separate annex, which parts? \_\_\_\_\_

\_\_\_\_\_

If you want part of your response, your name or your organisation not to be published, can Ofcom still publish a reference to the contents of your response (including, for any confidential parts, a general summary that does not disclose the specific information or enable you to be identified)?

### DECLARATION

I confirm that the correspondence supplied with this cover sheet is a formal consultation response that Ofcom can publish. However, in supplying this response, I understand that Ofcom may need to publish all responses, including those which are marked as confidential, in order to meet legal obligations. If I have sent my response by email, Ofcom can disregard any standard e-mail text about not disclosing email contents and attachments.

Ofcom seeks to publish responses on receipt. If your response is non-confidential (in whole or in part), and you would prefer us to publish your response only once the consultation has ended, please tick here.

Name

Signed (if hard copy)

## A6. Consultation questions

A6.1 In this consultation we set out the following consultation questions.

### Operational separation

Question 2.1 Do you agree with our proposals on operational separation including the proposed changes to the requirements and guidance? Do you agree with our proposal for a new requirement on the BBC to publish an Annual Statement on Operational Separation? Please provide reasons and evidence to support your answer.

### Supply and pricing of goods and services

We welcome views on all elements of our proposals and have highlighted three specific questions for stakeholders to consider in responding to us.

Question 3.1: Do you agree with our proposal that transfer prices for use of the BBC brands should be based on market prices?

Question 3.2: Do you agree with our proposals that:

- a) it is appropriate to retain the ability for the BBC to set prices based on costs in the absence of market information or where benchmarking would not be proportionate; and
- b) the calculation of cost in these circumstances should include direct costs, overheads and a contribution to the Public Service.

Question 3.3: Do you agree with our proposals for transfer pricing of shared business support services?

Please provide reasons and evidence to support your answer.

### Commercial rate of return

Question 4.1 Do you agree with our proposals to amend the rate of return requirements and guidance? Please provide reasons and evidence to support your answer.

### Monitoring, reporting and transparency

Question 5.1 Do you agree with our proposals on the monitoring, reporting and transparency requirements? Please provide reasons and evidence to support your answer.