The BBC's commercial and trading activities: A consultation on proposed modifications to Ofcom's requirements and guidance

BBC Response

September 2018

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Executive summary

The BBC welcomes the chance to comment on the revised requirements Ofcom proposes to place on the BBC to avoid the relationship between the BBC's commercial and public service activities distorting the market or creating an unfair advantage.

The BBC has a strong track record of ensuring compliance with state aid, competition law, and both Ofcom and the BBC Trust's regulatory requirements to ensure there is appropriate financial and operational separation between the BBC's public service and commercial activities. This is based on the range of measures and controls we have in place to ensure that our commercial activities do not distort the market as a result of their relationship with the BBC public service. This includes:

- The BBC Fair Trading Committee, a non-executive director led sub-committee of the BBC Board meeting quarterly to consider all aspects of the BBC's implementation of arrangements to comply with Ofcom's trading and separation rules.
- A governance structure backed by procedures which ensure there is appropriate separation between the BBC public service and commercial activities, including a dedicated decision making body for the BBC's commercial activities and clear procedures for managing any potential conflicts of interest, as well as guidance on information sharing.
- Arm's length commercial agreements in place between the BBC and its commercial subsidiaries for all goods and services traded internally, as well as published methodologies setting out the basis of charging for different goods and services.
- Measures to ensure that all relevant BBC staff, whether employed by the BBC or one of its commercial subsidiaries are aware of relevant regulatory requirements and BBC procedures, as well as dedicated points of contact – 'Fair Trading representatives' – in all BBC divisions and commercial subsidiaries.
- An annual Fair Trading Review including an Independent Fair Trading Audit to provide additional assurance to the BBC Board's Fair Trading Committee that BBC has in place appropriate compliance procedures, as well as the National Audit Office's regularity audit which specifically considers intra-group charging.

Most of these current controls did not come into being in April 2017 when Ofcom became responsible for BBC regulation, but date back several years to the previous Charter period and before. Since 2007 we have not received an upheld complaint about a breach of any of these regulatory requirements. This underscores how seriously the BBC takes these obligations.

We welcome some of Ofcom's proposed changes to the current regulatory framework, specifically:

- Revisions to make its regulations clearer and remove duplication – we welcome the additional clarity and transparency
- More proportionate and targeted information sharing requirements, specifically to reflect a more risk based approach
- A reduction in the frequency of current financial performance reporting, although we propose that annual reporting with appropriate triggers for reporting unsatisfactory performance would be more proportionate for both Ofcom and the BBC.

However we have concerns about the extent to which Ofcom has justified some proposed changes, with specific reference to its requirements under Section 3 (3) of the Communications Act 2003 and Clause 28 of the Agreement, as well as the extent to which Ofcom has considered the specific circumstances for regulating the BBC, rather than transposing requirements it places on other companies it regulates that have significant market power. Specifically:

- We are committed to transparency and are happy to publish further information about the governance of our commercial subsidiaries. However, we consider that Ofcom's proposal that we publish an annual statement of operational separation is wholly disproportionate and not targeted to an evidenced area of risk.
- We are committed to only undertaking viable commercial activities that return value to licence fee payers. We are concerned that some of Ofcom's proposals around financial reporting stray beyond Ofcom's powers to ensure we achieve a commercial rate of return, and into the territory of how we manage our performance against commercial targets, which is a BBC management responsibility.
- We are committed to providing Ofcom with information necessary to fulfil its duty to regulate the BBC. However, a number of Ofcom's proposals around financial reporting would require a significant amount of manual effort, without due consideration in this consultation for the impact this would have on the BBC, or adequate justification of why such effort would be necessary.

This response is divided into five main sections, which broadly map to the structure of Ofcom's consultation document:

- Operational Separation
- Supply and pricing of goods and services
- Commercial rates of return
- Monitoring, reporting and transparency
- Further general points

We also include for completeness a further annex on each of Ofcom's significant proposed modifications to the requirements and guidance document itself.

1. Operational separation

1.1 Governance of the BBC's commercial arm

Overall we agree with Ofcom that it is for the BBC to decide how best to structure our governance, including that of our commercial arm. We therefore welcome Ofcom's clarification on this area in the consultation and support Ofcom's proposal to not deviate in substance from the existing regulatory requirements. We also welcome Ofcom's further justification for regulation in this area, as well as the additions to the guidance which helpfully clarify how Ofcom may consider any potential concerns it has.

However, we remain concerned about several aspects of Ofcom's underlying rationale which drive its proposed regulatory interventions around separation. Ofcom's stated starting point for regulation of operational separation, as set out in 2.12, is that the relationship between the BBC and its commercial subsidiaries should be at 'arm's length'. This wording is used in the BBC's Framework Agreement with DCMS (the Agreement) in relation to Ofcom's duties in regulating the BBC. Specifically Clause 28 (1) ii sets out that this may include requirements to ensure that "the relationship between the BBC and its commercial subsidiaries are at arm's length on commercial terms". However this drafting in the Agreement is not deployed to mandate a general principle of separation between the BBC and its commercial arm, but rather in a description of something that may be relevant to how Ofcom approaches regulation of the BBC to ensure market distortion or unfair competitive advantage does not result from the BBC's relationship with its commercial activities. We consider that it more appropriately applies to financial separation, not operational separation and overall governance of the BBC, noting in particular the role of the 'arm's length principle' in transfer pricing. We therefore do not agree that this is an appropriate starting point from which to consider the extent of operational separation between the BBC and its commercial arm.

There are two important points that determine the BBC's current approach to governance of its commercial subsidiaries that we consider it may be helpful to set out:

1) The BBC's Royal Charter (the Charter) is clear at Clause 20 (3) j that the BBC Board has a duty to set "a strategy and governance arrangements for the BBC's commercial activities and for assessing the effectiveness of those activities."
    a. This clearly establishes the primacy of the main BBC Board over the governance of the BBC's commercial arm. The BBC's commercial activities must fit within this overall framework, and it would be incompatible with the BBC's remit to have a situation where the BBC's commercial activities operated without sufficient oversight and came into conflict with the BBC's public service activities. Clause 20 (6) of the Charter reinforces this by putting a duty on the BBC Board to secure the effective and efficient management of the commercial subsidiaries. BBC Commercial Holdings Board is the way that the BBC

Board exercises control – through the BBC executive - over the BBC's commercial activities. It is therefore not appropriate for Commercial Holdings Board to be independent of the BBC executive, or to operate at 'arm's length' from the BBC.

b. The Charter at Article 7(6) (a) envisages that the BBC's public service and commercial activities will both contribute to the fulfilment of a single set of public service goals. This reflects the nature of the Public Purposes themselves. For example, BBC Studios and BBC Global News Limited's (GNL) international commercial activities clearly play a role in delivery of the fifth Public Purpose "To reflect the United Kingdom, its culture and values to the world", as does the World Service. While the performance of the UK Public Services in relation to the Public Purposes is regulated by Ofcom through the Operating Licence, it is clear that the Public Purposes apply across the whole of the BBC's activities, including the World Service and commercial activities.

c. We note the recent findings of Public Accounts Committee (PAC)[1] and National Audit Office's (NAO) landscape review on the BBC's commercial activities[2] which clearly set out the need for strict BBC Board oversight over the BBC's commercial activities. The PAC, for example, was concerned that the BBC Board should be setting the appropriate balance between its public service goals and its commercial objectives. Ofcom does not seem to have considered these, or their relevance, as part of the rationale in its consultation for operational separation and governance. We consider that these recent reviews indicate an expectation of oversight and strategic alignment between the BBC and its commercial subsidiaries, which is consistent with the Charter and Agreement, rather than the strict separation that could be implied from Ofcom's proposals, which is not. We must take into account NAO and PAC views where relevant in setting up the governance of our commercial arm, and would prefer that these aligned with Ofcom's regulation, or had at least been clearly considered by Ofcom as part of its work.

d. We are concerned that Ofcom may be starting with objectives in its regulation of the BBC that more typically apply in monopoly regulation, rather than with the state aid concerns that underpin regulation of the BBC. For example, in setting requirements for BT Openreach, one of Ofcom's objectives is to explicitly prevent BT from having a group strategy, given the potential harm this could do to customers of Openreach. Ofcom appears to have brought this rationale into its

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[1] Public Accounts Committee, Report into the BBC's commercial activities: https://publications.parliament.uk/pa/cm201719/cmselect/cmpubacc/670/670.pdf

[2] National Audit Office, The BBC's commercial activities: a landscape review: https://www.nao.org.uk/report/the-bbcs-commercial-activities-a-landscape-review/

proposals for the BBC, including, for example, through Ofcom's proposed areas of focus on the governance of the BBC's commercial activities set out in A.14 in its proposed guidance. However, the Openreach model is clearly not an appropriate model for Ofcom in imposing separation requirements on the BBC, considering our Charter requirement to set strategy across the public service and commercial activities at BBC Board level. Moreover, as the BBC does not have significant market power, the theories of harm are different for the BBC than they are with companies like BT.

2) The "BBC Public Service" (as defined by Ofcom: the UK Public Services, non-service activities and trading activities) is not the same thing as the BBC legal entity. Clarity in this area is important to ensure the BBC Board and BBC directors, including the Director General (DG), are not inappropriately constrained in their ability to exercise the oversight duties detailed above.

   a. The BBC is the parent company of all of the BBC's commercial subsidiaries. It comprises the BBC's public service activities, the World Service, and also a range of functions working across the BBC group. In its discussion on transfer pricing in the consultation Ofcom notes that business services are provided across the BBC group; these relate to BBC group functions, which therefore must be accommodated within the BBC's organisational structure.

   b. As such we consider that, for example, Ofcom's reference to wanting to understand whether individuals sitting on BBC commercial subsidiaries' Boards/Executive committees are 'public service' employees or not is incorrect. The Charter sets out that the DG must be the chief executive of the BBC, and must be an executive member of the BBC Board[3]. His remit therefore explicitly covers all of the BBC's activities – commercial and public service. The DG is not a public service only role, even though he is an employee of the BBC legal entity. Likewise services such as Policy, Strategy, Legal and Finance support the DG (in his role as Chief Executive of the BBC) and the BBC Board, and, in that sense, the relevant directors for these services have a BBC group, rather than purely public service, remit.

   c. We recognise that BBC public service is often a convenient term to use when referring to the relationship between the BBC and its commercial subsidiaries, and that references in our correspondence with Ofcom and published documents often use this terminology. However, given the importance on clarifying how the BBC's governance is set up, we expect that we will henceforth more clearly delineate between BBC public service, BBC group, and BBC commercial activities to aid further transparency.

[3] BBC Charter, Clause25 (2)

1.2 Managing and reporting on conflicts of interest

We note Ofcom's desire to ensure that potential conflicts of interest are managed at all relevant levels of governance within the BBC, including in Commercial Holdings Board and the BBC's commercial subsidiaries' executive committees. We already have in place procedures to ensure conflicts are identified and managed at all relevant levels. We are happy to report on conflicts of interest to Ofcom, where relevant. We note that, as part of our commitment to transparency, we already publish BBC Board minutes which identify conflicts of interest.

We consider that the intention of Ofcom's proposal in this area, as set out at 2.53 in the consultation, would be to only report the 'regulatory' conflicts of interest arising in the boards and executive committees that Ofcom identifies in the consultation. As this would exclude any reporting against other matters of corporate governance, which are not within Ofcom's remit, we consider this a proportionate and targeted regulatory requirement.

1.3 Information sharing

As set out at 2.22 in Ofcom's consultation we have in place rigorous procedures to identify BBC public service information that may give rise to a risk of market distortion, and have put in place robust measures to manage such information. We welcome Ofcom's clarification about the legitimacy of sharing information that carries no risk of market distortion, which we consider fits with our current approach, and we therefore support this change as proportionate and targeted regulation. We set out further comments below.

Potential theories of harm

We consider it may aid transparency to set out details of how we currently approach information sharing between the BBC public service and commercial activities. We consider that there are two theories of harm in relation to the exchange of information between the BBC public service and commercial subsidiaries, on which our approach to sharing information and identifying risks is based:

1. BBC commercial subsidiaries may have access to information about BBC commercial processes which could provide them with an unfair advantage in the markets in which they operate (e.g. commissioning)
2. BBC commercial subsidiaries may have access to information about competitors which the BBC public service holds through its business interactions (e.g. information about pricing from independent producers or studio facilities businesses) that could provide the commercial subsidiaries with an unfair advantage

These relate to information held by the BBC public service. There is a range of BBC group functions that sit within the BBC legal entity but are not the BBC public service. By necessity information must be able to be shared between the BBC and its commercial subsidiaries for these functions to work effectively. We welcome Ofcom's acknowledgement of this point in A.12 in its proposed revised Guidance, noting the need to share information for shared business support functions.

We note Ofcom's stated concerns around commissioning, which clearly fits within the first theory of harm set out above. Commissioning is subject to separate regulatory arrangements including our code of practice and business framework. As we set out in our response to Ofcom's parallel consultation on commissioning we have successfully managed competition between in-house production and third parties under the Window of Creative Competition (WOCC) under the previous charter, without the separation requirements between the BBC public service and BBC Studios that are now set out in Ofcom's requirements. We reiterate that it would be not in the BBC's interests to distort this process – as is demonstrated by the BBC's successful operation of the WOCC – and Ofcom's commissioning consultation acknowledges this point.

Beyond the two theories of harm set out above, we cannot identify any further risks that would require regulation to address. Ofcom's consultation document does not provide any robust or considered analysis in this area. It is unclear to us, for example, exactly how the other areas Ofcom has cited could manifest in unfair advantage for a BBC commercial subsidiary – e.g. on distribution of Children's content. We would expect such an analysis would be the starting point for proposed regulatory intervention in line with the principles of better regulation and Ofcom's duties under Section 3 (3) of the Communications Act 2003.

Ofcom's proposals

We agree with Ofcom that it would not be proportionate to explicitly define what information can and cannot be shared in all circumstances. We also agree that the emphasis should be on preventing the sharing of information where there is a significant risk of market distortion, rather than only permitting sharing where there is 'no risk'. Ofcom notes in 2.29 that much information may carry 'lower or no risks'. Ofcom's consultation also sets out at 2.33 that that to implement this we should assess what type of information could put the BBC's commercial subsidiaries at an unfair advantage, then take steps to prevent any risk materialising. This is in line with our current approach and we agree that practically speaking in assessing the risks of sharing information we should seek to identify risk, not to identify the absence of a risk.

However, the proposed drafting in the requirements sets out that sharing is permitted only where there is 'no' risk, which could be interpreted to be considerably narrower. We consider it would be more proportionate to only prevent disclosure of information where there is an identified risk of market distortion, and that the requirements should be drafted reflect this. We note that this would reflect good regulatory practice in other sectors where regulators define specific types of sensitive information on which to place appropriate controls, not the other way around.

Global News Limited

We welcome Ofcom's clarification around the need for GNL and BBC News to work closely together in order to fulfil the mission and public purposes. We consider it is imperative that GNL and BBC news are able to maintain a close working relationship, and that there must be editorial alignment between GNL and BBC News in order to ensure BBC News is a consistent product. For that reason we do not consider it practical or desirable to restrict the information that can be shared between BBC News and GNL, unless it has been identified that it could give rise to a significant risk of market distortion.

2. Supply and pricing of goods and services

2.1 Public service buying goods/services from commercial subsidiaries

We welcome Ofcom's clarification in the consultation that transfer pricing requirements apply to transactions between the BBC and its commercial subsidiaries where the public service is both a 'buyer' and 'seller' of services. This reflects the approach the BBC has taken to implementing Ofcom's current requirements, as set on in our published transfer pricing methodologies[4]. We therefore support this proposed change to the regulatory framework, as it reflects the approach we have to date considered necessary to ensure there is no risk of market distortion or unfair commercial advantage as a result of our commercial subsidiaries' relationship with the BBC public service.

However, we are concerned about the practicality of Ofcom's proposal that, effectively, the BBC must assure itself that it is paying a market price for access to BBC commercial subsidiaries' goods and services. We consider this could be disproportionate, subject to further clarification from Ofcom on what types of evidence it would expect the BBC to be able to provide to satisfy this requirement. We consider this would mainly apply to BBC Studioworks, noting that BBC Studios' commissions for the BBC are not considered in Ofcom's framework, as there are additional requirements around the prices the BBC pays for content.

The majority of Studioworks' client transactions are sales of studios and post production services on the 'spot' market (e.g. a client requiring studio space will review the market to see what suitable facilities are available for their required dates, gather quotes from relevant suppliers and then select the supplier who provides the best mix of factors such as price, location and service offering). The same process applies for transactions with the BBC.

Within the BBC public service, those buying Studioworks' services have a history of purchasing facility services from a range of suppliers and knowledge of the markets. The BBC has negotiated 'ratecards' with a range of providers, including BBC Studioworks, and purchases services from each of them using this ratecard as a negotiating start-point. The ratecards are simply a framework price list and do not guarantee that any work will be placed with the supplier, nor is there any guarantee that ratecard prices would be charged, given the nature of the market as set out above.

However these rate cards do constitute a form of benchmarking, and reflect the market norm for the purchase of these types of services. We would consider that to satisfy any regulatory obligations these rates cards would be sufficient evidence, even though they may not directly correspond to actual prices in any given negotiated transaction. Any additional formal benchmarking requirements against services provided by Studioworks – but not for other suppliers – would place

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[4] All of our transfer pricing documents can be accessed from this page: http://www.bbc.co.uk/corporate2/insidethebbc/howwework/policiesandguidelines/fairtrading.html

Studioworks at a competitive disadvantage to its peers, which we do not consider is Ofcom's intention. This is because there is a risk that further benchmarking would likely disincentivise BBC purchasers from using Studioworks as the administrative burden may become too cumbersome for what are often short-term, 'spot' market studio requirements. This could arise if, for example, purchasers were forced to seek internal BBC Fair Trading approval for each transaction, or to conduct additional price benchmarking beyond what might be available through ratecards. It should be further noted that Studioworks' ratecard with the BBC represents commercially confidential information and should never be disclosed publicly as this would place other market place competitors at an advantage to Studioworks.

We further note that all purchasing decisions are governed by the BBC's General Duty under the Charter (Clause 16) to exercise rigorous stewardship of public money. This acts as an additional safeguard in ensuring that the BBC would not pay above market rate for any goods or services, including those provided by its commercial subsidiaries. This is then scrutinised by the NAO as part of its obligations to audit the BBC, including looking at Regularity and Value for Money. We consider there are therefore sufficient safeguards and controls in place to prevent any potential cross subsidy arising in this area, without the need for overly burdensome regulation.

2.2 Consistency of the BBC's approach to setting prices

We currently take a consistent approach to setting prices for our commercial subsidiaries and third parties. As set out in our published principles for transfer pricing[5], we treat our commercial subsidiaries and third parties equally, which extends to treating all third parties equally also. We do this for practicality, as well as to ensure regulatory compliance. It is most straightforward to use the commercial agreements we have in place between the BBC and its commercial subsidiaries as the basis for any pricing with any third party, given we have developed these in part to meet our regulatory obligations and 'price' BBC goods and services. We therefore welcome Ofcom's clarification in this area, which reflects current practice in the BBC, as well as Ofcom's current guidance.

We have some concerns however with elements of Ofcom's stated justification for these requirements, which we consider is also the basis of Ofcom's proposal for additional reporting which we discuss further in 4.4.2, and which do reflect our understanding of where potential risks are in setting transfer prices. Ofcom's stated concern around discrimination is set out at 3.14 (b) in the consultation document, specifically that "there is a risk that the Public Service discriminates in the prices or terms and conditions it offers…to its commercial subsidiaries compared to third parties" or that "the Public Service could discriminate between different third parties in way that harms fair and effective competition", with the reference to

[5] BBC Fair Trading: Principles for Transfer Pricing, April 2018: http://downloads.bbc.co.uk/aboutthebbc/insidethebbc/howwework/policiesandguidelines/pdf/transfer_pricing_principles_april_2018.pdf

products sold downstream. Discriminating between parties is not in and of itself likely to cause harm where there are clearly differentiated requirements such that those parties are not in equivalent positions to each other. Price discrimination is a common practice across the economy and can be pro-competitive; it is undue discrimination between similarly-placed parties based on arbitrary differences (such as the simple fact of being a BBC commercial subsidiary) that can distort the market. As such it is common to discuss broadly equal, though not identical, treatment of similarly-placed market participants.

Moreover, we consider that Ofcom's reference to potential harm to downstream markets seems more reflective of the regulatory interventions that Ofcom may impose on companies with significant market power, like BT or Royal Mail. The BBC does not have significant market power. This means that we lack the ability to distort markets in the way that Ofcom describes. To illustrate with an example of BBC office space:

- As set out in our Group Trading Manuals, the BBC provides office space to BBC Studios, for which we charge market price, based on externally sourced benchmarks for equivalent office space where relevant. We also provide office space to independent producers, specifically for use with BBC commissions, in two BBC buildings.
- The BBC does not have significant market power in the provision of office space in any reasonable definition of a market. We provide facilities to third parties because it helps them provide services to the BBC, not because we are a sole supplier. We also want to ensure the best utilisation of BBC assets to drive value for money for licence fee payers.
- If we offered office space to independent producers on unfair terms, or at prices significantly above market, they would easily be able to substitute supply with an alternative commercial property provider.
- Moreover, the ultimate 'downstream' impact would simply fall back on the BBC as the buyer of independent producers' output for the UK Public Services. There is no incentive for the BBC to want to discriminate in this scenario, regardless of the regulation in place.
- As such we consider that the only robust theory of harm around these trading activities would be that the BBC was somehow able to undercut a given market price, which could crowd out competitors or otherwise prevent fair and effective competition from developing. However, in most instances we do not consider that the BBC's trading activities would be on such a scale as would be necessary to have the level of impact which could give rise to these risks.

Ofcom's duties under the Charter and Agreement as regards regulation of the BBC arise from market distortion concerns originating in the state aid regime, not the competition prohibitions on the abuse of dominance. We are concerned that some of Ofcom's discussion around theories of harm suggests that Ofcom considers the latter to also be relevant. Ofcom has not presented any evidence that the BBC is dominant or holds significant market power.

2.3 Pricing for different types of goods and services

Charging for business services

We welcome Ofcom's clarification that BBC Business Services should be charged on the basis of cost, rather than market benchmarks. We also note that, building on the points we set out in 1.1 on the difference between the BBC legal entity and the BBC public service, such business support services would effectively correspond with BBC group functions. We have so far approached the implementation of Ofcom's current requirements on the basis that the 'market price' for these types of services would be the costs that another commercial operator of a similar size/type would expect to incur in providing these services, and therefore by ensuring that the BBC's cost of provision is aligned with relevant peers. This in turn aligns with Ofcom's stated intention that the BBC should charge based on the 'opportunity cost'. For legal services, for example, we would expect relevant comparators to be in-house legal teams providing legal advice, with external legal support and advice brought in as required and passed through to the subsidiaries (where not directly contracted by them). If the 'market price' were defined as effectively the 'spot' external price for this service, the BBC's commercial subsidiaries would be put at a disadvantage to its commercial peers through its receipt of group services, which is clearly not Ofcom's intention.

We would welcome further clarification from Ofcom on the definition of 'long run cost of provision' that it proposes we should use to set transfer prices for business services – we consider this additional transparency would benefit us and other stakeholders. We expect that, to continue with the example of legal services, we would include the following elements within transfer prices:

- Salary costs for the relevant people
- Salary related overheads, including pension contributions and national insurance
- Relevant non-salary overheads including IT costs (e.g. laptops, IT support) and accommodation (e.g. if based in a BBC office)

We consider this approach should be compatible with Ofcom's proposal. In implementing Ofcom's proposed changes we will continue to ensure that the BBC's cost base aligns with relevant comparators, noting our wider obligations around effective stewardship of public money and maximising the amount of money the BBC has to spend on content. One area where we expect that one of our group business services may not reflect the cost a competitor would face is pensions. There are a number of staff in the BBC's commercial subsidiaries on legacy BBC group defined benefit schemes. The employer contribution rate required for these pensions changes and depends on a number of factors such as changes in macro longevity assumptions and investment strategy of the BBC Pension Scheme. We are happy to develop an appropriate methodology based on cost, in line with other group business services, for charging pension costs.

Different categories of goods and services

Given Ofcom's welcome clarification around the treatment of business services, we consider it is worth setting out the different types of goods and services the BBC provides to its commercial subsidiaries and vice versa, and how we consider this would align with Ofcom's proposed framework. We will update our transfer pricing documents in due course to set out further details.

We consider there are four relevant categories of goods and services, which should use different charging approaches:

- BBC group business services, provided within the BBC group only (e.g. BBC HR): We would expect to charge 'long run cost' for these services in line with Ofcom's proposal. In a number of instances this will continue to involve passing through a market price the BBC pays to an external third party provider.
- Intangibles or marketable media services (e.g. BBC IP): We would expect to continue to base charges on market practice and market prices, based on benchmarking where relevant. This would also cover goods or services that represent the core business of a commercial subsidiary (e.g. BBC Studioworks selling studio space to the BBC public service)
- Other services provided by the BBC public service to the BBC's commercial subsidiaries and third parties, for which the BBC is not the sole source of supply (e.g. production facilities in the Nations and Regions). We would expect to continue to base charges on market practice and market prices informed either by benchmarking or competitive market processes (which could include formal tendering, as well as commercial information that may be revealed through transactions).
- Other services provided by the BBC public service to the BBC commercial subsidiaries and third parties, for which the BBC is the sole source of supply (e.g. BBC Integrated production sites): We would expect to continue to base charges on all relevant direct costs.

All of these categories of goods and services, except the final category, would also be 'bought' by the BBC public service from its commercial subsidiaries. We do not initially consider there are any services provided by commercial subsidiaries to the BBC where the commercial subsidiary is the sole source of supply.

Adding a margin to the prices for certain services

While we generally consider the above a robust and proportionate approach to transfer pricing, which is compatible with Ofcom's proposals, we continue to have concerns about the need to add on a 'margin', or contribution to the BBC public service, for services provided by the BBC public service to the BBC's commercial subsidiaries and third parties, for which the BBC is the sole source of supply.

This approach of charging all relevant direct costs would only apply where there is no discernible 'market' for these goods or services to enable benchmarking. If a market exists, we would be required to identify market practice and set charges on the basis of market prices, which would theoretically include a reasonable margin. In the absence of such a market, there can be no requirement to add on a wholly notional margin in order to mimic the approach of a non-existent market operator. Adding on a margin would only have the effect of increasing prices for end consumers, which may include the BBC, without any such price increase being necessary to prevent market distortion. We urge Ofcom to consider further whether this is a desirable outcome for consumers. Moreover, the BBC would incur unnecessary costs to calculate an appropriate margin, particularly given that there is no BBC public service cost of capital.

In the example of BBC Integrated Production Sites – which are sites setup for named BBC productions like EastEnders – adding on a margin would simply require an increase in BBC Content's commissioning budgets, with the additional revenue flowing back through to BBC Workplace via the production company. Likewise, to access BBC Archive Library Services, for which the BBC is the sole supplier, there is no discernible consumer benefit in adding a margin on to the BBC's costs as the BBC is not competing against other, commercial, providers of the BBC archive.

Setting prices above cost or market price

We also note Ofcom's helpful clarification that we can charge more than cost or market price for goods and services. We would welcome further clarification that were we to do so, Ofcom would recognise this when considering our achieved or targeted rates of return against commercial rates of return. In the absence of any such clarification it is hard to envisage a scenario where the BBC would be prepared to take advantage of such a provision. Ofcom acknowledges in C.6 about the need to consider transfer pricing *and* rate of return requirements together, not in isolation.

2.4 Brand fee

We welcome Ofcom's clarification in this document on the rationale for the BBC to charge a brand fee to its commercial subsidiaries. We note that, as Ofcom sets out, we currently charge the BBC's commercial subsidiaries for the use of the BBC brand, where relevant. Further details of this are set out in our published brand fee methodology documents[6], which includes the instances where the commercial subsidiaries do and do not pay a brand fee. However, we have several concerns with some aspects of Ofcom's rationale for charging a brand fee.

Ofcom sets out at 3.22 that the BBC brand's development and maintenance has been funded by the licence fee. This is partly correct, but ignores the important

[6] http://www.bbc.co.uk/corporate2/insidethebbc/howwework/policiesandguidelines/fairtrading.html

contribution that the BBC's commercial subsidiaries also make, and have made, to the BBC brand, particularly in the (often global) markets in which they operate.

- The BBC was recently ranked the most trusted TV news brand amongst American viewers[7]. The only BBC TV news brand available in the US is BBC World News, which is not funded by the licence fee, but is a commercial activity run by GNL. This contributes to the overall equity of the BBC brand, not simply its commercial value to GNL
- Moreover both BBC Studios and GNL play a leading role in protecting the brand around the world, in line with the BBC's obligation under the Agreement to not jeopardise the BBC brand when undertaking commercial activities. Both also contribute to the BBC's international trade mark fund which funds legal action against brand infringers.
- Given this, we consider that the BBC brand is a BBC group, not public service, asset. It cannot be established with any degree of certainty that the equity and value of the BBC brand for any commercial activity is solely a result of BBC licence fee funding.

Furthermore, the BBC brand is not clearly a driver of sales in all of the markets in which the BBC undertakes commercial activities.

- In TV production, brand is not a significant determinant of winning a commission. Far more important would be creative talent and the ideas. Viewers often have limited awareness of the identity of who produced a programme of the BBC's involvement.[8]
- BBC Studios effectively has a production arm operating under the BBC brand, liable to pay a brand fee, and separate indie brands which are not. This is entirely consistent with Ofcom's stated rationale for the BBC levying a charge to its commercial subsidiaries to use its brand. In each circumstance creative talent is the driver of sales, rather than the BBC brand.
- BBC Studioworks is somewhat distinct from the other commercial subsidiaries in that it does not directly exploit BBC content, does not sell BBC products and does not routinely market itself using the BBC brand in order to drive sales. Instead, it simply markets itself as a facilities provider. The BBC logo has purposely been de-emphasised in Studioworks' branding in order to help illustrate to the market that the company's facilities are available for hire by all broadcasters and production companies. Sales are driven by its track record in the facilities sector and the established relationships it has with all these industry clients.

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[7]see https://www.pressgazette.co.uk/bbc-tops-poll-of-most-trusted-tv-newsbrands-in-us-with-fox-news-in-second-place/

[8] For example, *Poldark* (produced by Mammoth Studios, part of ITV Studios) is usually described as a BBC programme. *Unforgotten* (broadcast on ITV and produced by Mainstreet Pictures) is distributed by BBC Studios, and when watched on Netflix it is the BBC Worldwide brand that is most prominent to Netflix viewers.

- Ofcom present no evidence as to whether it would be the market norm for brand fees to be charged in the markets in which the BBC's commercial subsidiaries operate. We do not consider that Ofcom has therefore fully considered whether such a requirement is necessary to put the BBC's commercial subsidiaries on a level playing field with their commercial peers, rather than at a potential disadvantage.

While we expect to continue to consider charging a brand fee, in line with Ofcom's proposed requirements, we agree with Ofcom that identifying the market price may be challenging, partly for the reasons set out. We do not consider that the opportunity cost to the BBC is necessarily the value of the BBC brand to an unrelated third party. So any benchmarking would have to take into account the contribution back to the BBC of the additional value realised by its commercial subsidiaries' operations. Moreover, we consider that finding relevant comparators for benchmarking will be difficult. Intra-group charging of this nature is often a function of financial manipulation (i.e. for tax reasons) rather than to reflect a fair value being paid to use a brand. Unrelated parties may enter into franchise agreements, but these are different in nature to the regulatory requirement that Ofcom proposes.

We expect that, following Ofcom's clarification, we will update our approach to charging for the BBC brand later this year to ensure it remains aligned with the market and Ofcom's requirements. We also welcome clarification from Ofcom that, as Ofcom is proposing that we can set transfer prices at a level higher than market price if we wish, this would apply equally to a brand fee and, if so, such charging would be taken into consideration when Ofcom is assessing our target or actual rates of return against commercial rates of return.

3. Commercial rates of return

3.1 Commercial and target rates of return

We have some significant concerns about Ofcom's interpretation of the BBC Charter and Agreement, specifically Ofcom's interpretation of the rules it considers appropriate to put in place to ensure that the BBC's commercial activities are "undertaken in line with normal market principles, including making a commercial rate of return"[9]. Specifically, we consider that Ofcom's proposals that the BBC's failure to achieve its targets for each line of business and commercial subsidiary should be the trigger for additional reporting to Ofcom may not be within Ofcom's powers, as set out in the Agreement.

Ofcom's proposals in certain respects conflate two distinct concepts:

1) A *commercial rate of return* (i.e. what a market operator would expect to achieve for a particular line of business); and
2) The *BBC's commercial targets* (i.e. the targets that the BBC Board sets for each line of business within the BBC's commercial arm).

Commercial rate of return: We consider that a commercial rate of return is essentially a 'floor' (or potentially a 'floor and ceiling') reflecting the level of return that an investor would expect to make in the market. We currently (and expect to continue to) determine this through benchmarking of relevant competitors or comparators for each of the BBC's main commercial subsidiaries and their lines of business where relevant. This is the regulatory control aimed at ensuring the BBC does not afford its subsidiaries a level of commercial tolerance that amounts to unfair cross-subsidy.

The BBC's commercial targets: In setting targets for each main commercial subsidiary and line of business, we take into account what a commercial rate of return would be, and then target a return that is above this floor (or within the range established), but which also reflects the ambitions the BBC has for its commercial arm, in line with the BBC's group strategy. As such the BBC's targets are likely to be above the level necessary to achieve a commercial rate of return (i.e. to ensure the BBC does not afford its subsidiaries a level of commercial tolerance that amounts to unfair cross-subsidy). The BBC should be free to set stretching commercial targets to ensure that licence fee payers get the most benefit from the BBC's commercial activities, provided that these targets are within a reasonable commercial rate of return range. Ofcom has a clear legitimate interest in assuring itself that the BBC does not afford its subsidiaries a level of commercial tolerance that amounts to unfair cross-subsidy. However, Ofcom is not responsible for managing the performance of the BBC's commercial activities. This is clearly the responsibility of the BBC. The BBC is required to ensure that its commercial activities earn a commercial rate of return, which Ofcom has then further defined to place such a requirement at the level of each line of business. The current requirements and guidance then require the BBC

[9] BBC Charter, Clause 46 (6)

to report to Ofcom each year the forward looking commercial rates of return we consider relevant to each line of business, although the accompanying guidance then suggests that this should also include our expected rates of return. As such we have so far reported to Ofcom our commercial targets, together with the background information on commercial rates of return we have identified to demonstrate why these targets are appropriate. Ofcom then monitors financial performance through quarterly reporting and the publication of our annual report and accounts for the BBC's commercial subsidiaries.

Ofcom's proposals, specifically around reporting, represent a significant deviation from this framework, which we do not consider have been considered adequately given the fundamental changes they propose. Ofcom now proposes that we have a formal obligation to report to it our target rates of return (i.e. the BBC's commercial targets), including reasons and evidence to support these. Building on this, Ofcom's proposals would then also require the BBC to report to Ofcom for a failure to achieve a target rate of return, as if it represented a failure to achieve a commercial rate of return. As set out above, these are distinct concepts. A line of business could fail to hit a deliberately ambitious target, but still comfortably achieve a commercial rate of return. We do not consider this would be proportionate, and would risk incentivising the BBC to not set the most stretching targets for the performance of its commercial arm. Particularly in light of PAC and NAO comments about the need to ensure that licence fee payers get the best possible return, we do not consider this is an outcome that Ofcom would wish through its regulation of the BBC. This point is highlighted by Ofcom in its proposals around commercial rates of return in C.12, but this is inconsistent with Ofcom's proposed reporting requirements.

Further, as part of its justification for this proposed reporting requirement, Ofcom notes at 5.80 that "Neither the published or 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". This is set out under the heading "If the subsidiaries and lines of business are not making a commercial rate of return, what steps is the BBC implementing?". We reiterate that we do not consider that Ofcom has the powers to intervene in the event that we fail to meet our targets, provided we still make a commercial rate of return. It is for the BBC to manage its commercial activities, including their performance against targets. In practice the range of potential actions that BBC management would take in the event that a commercial activity, line of business or subsidiary is not expected to hit a commercial target would depend on the circumstances. Performance below target could be due to a range of factors, some of which, like wider industry and market conditions, may not be within the control of BBC management to address. As such any action would need to be considered on a case by case basis. All of our lines of business and main commercial subsidiaries achieved commercial rates of return last financial year, and are targeting commercial rates of return this financial year. As such there is no reason why we should have reported any information to Ofcom on steps we have taken, or are taking, to ensure we earn a commercial rate of return. There is no evidence to suggest that the BBC is failing to report relevant failures such that further regulation in this area is required.

We consider the current requirements, which use a failure to achieve a commercial rate of return as the trigger for further reporting, are more proportionate, and more clearly aligned with Ofcom's obligations under the Charter and Agreement. For the avoidance of doubt we agree that a failure, or expected failure, to achieve a commercial rate of return is sufficient to justify additional reporting to Ofcom, to ensure Ofcom can perform its duties. However, in the normal course of business, and if the BBC's commercial subsidiaries and their lines of business are making, targeting and expecting to achieve commercial rates of return, we consider there should be a high evidential bar for Ofcom to justify significant reporting by the BBC. We do not consider that Ofcom has presented the necessary evidence to justify these proposed changes.

3.2 Period of time over which we need to assess rates of return

We welcome Ofcom's clarification in its proposed requirements and guidance around the period of time over which we are expected to consider and achieve commercial rates of return. We note that Ofcom's guidance in the current trading and separation rules makes the point that it "would expect every line of business to be profitable over an appropriate time period" and that "a line of business need not generate a profit every year particularly if it is a new activity". We agree with Ofcom that an assessment of rates of return must be carried out over an appropriate period of time, and that this may vary for different lines business. It may also take into account factors like the maturity of an activity. Ofcom notes that the current requirements do not specify that a commercial rate of return should be earned over an appropriate period of time.

However, we do not consider that Ofcom's proposal that we report our target rates of return over a period aligned with our business plans would be a proportionate or targeted regulatory intervention. We consider reporting over this time period is only relevant if, in the next financial year, we do not project to make a commercial rate of return in the commercial subsidiary or line of business.

We would expect that if a commercial subsidiary or line of business targets a commercial rate of return in the next financial year this should be sufficient to satisfy Ofcom in carrying out its duties. Targets for future years would be less precise, and may therefore be of limited relevance to Ofcom. The BBC currently formally sets budgets one year ahead. This is a result of various reasons, including:

- The way the licence fee is calculated each year, which is not within the BBC's control.
- The BBC's consultation each year on its annual plan, which sets out our creative remit. This is an important exercise in determining budgets for different parts of the BBC.

- Regulatory uncertainty around potential material changes to the BBC's commercial and public service activities, for which approval is not within the BBC's control.

The BBC Board, as set out, must consider the performance of the whole of the BBC group in determining commercial targets. For example, the Board may wish to set more stretching commercial targets if it also has ambitious plans for the BBC public service that cannot be met by the licence fee alone. It is vital for the BBC to maintain this link between its public service and commercial activities, as the latter exist to support the former and must continue to fit with the BBC's mission and public purposes. A requirement to report to Ofcom commercial targets for a period in advance of the BBC budget risks undermining these important linkages, and the necessity that the BBC's public service and commercial activities work together.

However, for the avoidance of doubt, we do consider it appropriate to report to Ofcom for a whole business plan period in the event that the target for the next financial year is not aligned with a commercial rate of return.

3.3 Lines of business and commercial subsidiaries

We welcome Ofcom's clarification around our requirements in relation to notification of what our commercial lines on business are. We also welcome Ofcom's clarification that it should be for the BBC to determine what our lines of business are, and that these should mirror how the business is managed by the BBC.

The BBC's commercial subsidiaries operate in dynamic and fast changing markets. It is imperative that there is sufficient flexibility for the BBC to reorganise aspects of its commercial arm, including rearranging lines of business to better reflect market norms or the BBC's commercial strategy. We consider Ofcom's proposal that we inform it of proposed changes to the composition of our lines of business is a practical and proportionate approach to providing Ofcom with necessary oversight, while maintaining sufficient commercial flexibility for the BBC.

We also welcome Ofcom's proposed clarifications around how the regulatory framework will treat commercial subsidiaries as well as lines of business. We consider that Ofcom's revisions broadly reflect the way we have interpreted the current rules, in that we expect each main commercial subsidiary to both target and achieve a commercial rate of return, as well as each line of business. However, we have concerns about potential misinterpretation of the proposed regulatory framework as proposed by Ofcom. We consider it would be clearer if Ofcom's requirement related specifically to each line of business in the BBC's commercial arm, as well as each *main* commercial subsidiary. We agree with the points raised by Ofcom in 4.8 to 4.12 that it is important for each significant part of the BBC's commercial arm to achieve a commercial rate of return. However, we think that placing a requirement on each subsidiary could be interpreted as applying to either each of the BBC's main commercial subsidiaries (BBC Studios, BBC Studioworks, and GNL) or to each legal entity sitting under the BBC's commercial arm (e.g. also BBC World News Distribution Limited, which sits under GNL). From the justification set out by Ofcom in 4.9 for the proposed changes, we understand that Ofcom intends the former interpretation to apply, as the latter would be too granular. We note that the NAO landscape review of the BBC's commercial activities listed 110 subsidiaries owned by the BBC undertaking commercial activities as at July 2017[10].

[10] National Audit Office, The BBC's commercial activities: a landscape review, Full Report p4

4. Monitoring, reporting and transparency

We are committed to transparency and to providing all stakeholders, including Ofcom, with the information they need to understand the structure and performance of our commercial activities. We note that the BBC Board is conducting its own review of the BBC's obligations and existing practice around disclosure and transparency in its commercial subsidiaries[11]. We already publish a range of information about our commercial activities, including in the BBC Annual Report and Accounts, the BBC Commercial Holdings Financial Statements, our published transfer pricing documents and other relevant information on the BBC Website and those of our commercial subsidiaries, in addition to the information available through companies' house.

We consider that any proposed regulatory requirements that Ofcom considers necessary in this area must be robustly justified, and that transparency is not in and of itself a sufficient justification for regulatory intervention. Indeed it is well established that in competitive markets inappropriate levels of transparency can be detrimental to fair and effective competition.

Ofcom's consultation document sets out in 5.5, as the justification for its proposed revisions to its reporting requirements for the BBC, that it has "identified gaps in the existing reporting requirements" based on its assessment of the information it currently receives from the BBC. However, Ofcom has not clearly established in this consultation what these gaps are, and how they prevent Ofcom from being able to discharge its duties to ensure the BBC's commercial activities do not distort the market or receive an unfair commercial advantage as a result of their relationship with the BBC public service.

We also note that Ofcom has the power under Section 47 of the Charter to request information from the BBC if it has legitimate concerns about the potential for market distortion. We would therefore expect that Ofcom's reporting requirements need to be set at a proportionate level, taking into account the burden of regulatory compliance they place on the BBC, in light of Ofcom's wider information gathering powers, and taking into account the BBC's longstanding track record of Fair Trading compliance.

We set out further details in this section on Ofcom's main proposals.

4.1 Frequency of financial performance reporting

We welcome Ofcom's proposal to reduce the frequency we are required to report from quarterly to biannually. Having considered Ofcom's rationale for us providing periodic reporting, as well as the performance of our commercial activities, we propose instead that annual reporting, combined with an obligation for the BBC to inform Ofcom as soon as practical if we expect a commercial subsidiary or line

[11] https://www.bbc.co.uk/mediacentre/statements/transparency-review-terms-of-reference

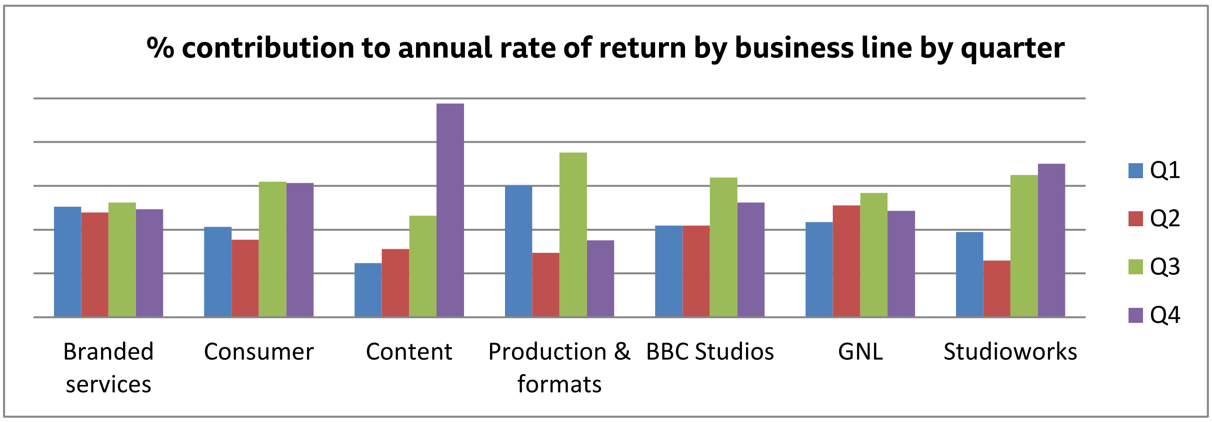
business would fail to make a commercial rate of return within a given financial year or over an appropriate period, would be more proportionate. It would reduce the frequency of information exchanged between us and Ofcom, and therefore the costs on both sides to prepare and review these reports, while ensuring that Ofcom has more effective oversight over any potential non-compliance with our obligation to earn a commercial rate of return.

Ofcom sets out in 5.99 that biannual reporting would enable it 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". However, as we set out above, Ofcom should be concerned mainly by whether or not we achieve, or will achieve, a commercial rate of return, not our targets. Where we do not achieve a target rate of return, but do achieve a commercial rate of return, we consider it would be proportionate for us to set out to Ofcom at year end the reasons for any variance between targets and achieved results. As we do not consider there would be any regulatory concerns (because a commercial rate of return would have been achieved) we would consider this should be sufficient for Ofcom to fulfil its obligations around monitoring the performance of the BBC's commercial activities.

Moreover, we note that Ofcom's proposed requirements at D.16 would already require us to report to Ofcom in the event that we identify that a commercial subsidiary or line of business in not expected to earn a commercial rate of return over an appropriate period. Practically speaking, we would expect that if in any financial year we had targeted a commercial rate of return, but subsequent changes meant that we longer expected to achieve a commercial rate of return, this clause would (and should) require us to report to Ofcom. This provides a more immediate mechanism for Ofcom to receive information about any potential non-compliance with the requirement that we make a commercial rate of return, rather than waiting for the next reporting deadline. This would allow Ofcom to have effective oversight, without requiring the preparation of reports on an ongoing basis.

We have also analysed our quarterly reports to Ofcom for the 2017-18 financial year to identify the extent to which quarterly or biannual reporting sheds light on the annual performance of each subsidiary or line of business in a meaningful way (i.e. does Q1 or H1 say much about full year performance?). This aligns with our regulatory obligation to earn a commercial rate of return over an appropriate period of time. At a minimum, we would consider an appropriate period to be a financial year. Ofcom recognises this point in its proposal to not require reporting of commercial targets more regularly than annually, noting the alignment with the BBC budget process, and in its discussion around its proposal that we report target rates of return further into the future (i.e. it is implied that an appropriate period may be longer than one year).

Revenue earned in nearly all (five out of seven) business areas is cyclical in nature, for example, almost half of content sales occur in the final quarter. We consider this is in line with the markets in which these lines of business operate. We note that income in Q3 and Q4 is generally higher across the board than for Q1 and Q2. As such reporting actuals biannually is not necessarily indicative of trends across the financial year, and therefore cannot make a meaningful contribution to Ofcom's ability to discharge its regulatory functions in this area. As with revenue, each quarter's contribution to annual profit is not consistent through the year, partly as result of the cyclical nature of revenue. The chart below illustrates this with data for 2017-18:



Again, profit over different periods in the financial year is unlikely to indicate trends or the overall picture for the financial year as a whole, which we consider is the most relevant yardstick by which to measure the performance of the BBC's commercial subsidiaries. We welcome further engagement with Ofcom around our proposals, or whether there are other alternatives that would ensure Ofcom receives timely information about any potential non-compliance with our regulatory obligations while minimising the ongoing effort for both us and Ofcom.

4.2 Publishing additional information about governance and separation

We are committed to transparency and are happy to publish on our website further information about the governance of our commercial subsidiaries, in addition to the information we already publish. We consider that this would provide stakeholders with the information necessary to understand how we approach operational separation, without the need for us to publish an annual statement on operational separation, as Ofcom also proposes.

Our proposals for publishing additional information

Ofcom proposes that we provide greater transparency around the governance of the BBC's commercial subsidiaries, by publishing more information to the BBC website. We recognise that we could be more transparent in this area, and we propose to publish the information set out below as soon as practical, and before we expect Ofcom to reach a decision on these revised requirements. This will ensure stakeholders have a better understanding of our governance structure and processes. This additional information will include:

- Structure, roles and responsibilities of different boards and executive committees for the BBC's commercial activities

- A list of who sits on each board and executive committee – names and job titles
- The terms of reference for BBC Board, Executive Committee, Commercial Holdings Board, and each commercial subsidiaries' executive committee
- Guidance on conflicts of interest (if not covered in Terms of Reference) and information sharing at BBC Board and Executive Committee

While this information will in some areas duplicate information already in the public domain, we consider that there is a benefit to stakeholders to bring it together to provide an overview of how commercial governance at the BBC works. We also commit to keeping this information up to date.

As part of our response to Ofcom's consultation on commissioning for the BBC public service, we are also committing to publishing an annual TV supply report, the first of which will be published in April 2019. This will provide significantly more information around the commissioning process, which we note is one of Ofcom's main concerns around separation in the BBC.

The information we now commit to publishing will supplement the existing information we publish in relation to our commercial activities, including the assurance we already provide around separation. The BBC Annual Report and Accounts contains a Fair Trading Report, which includes the opinion of the independent Fair Trading Auditor. The remit of the Fair Trading Audit includes separation between the BBC public service and commercial activities, as the audit opinion clearly sets out. We consider this already provides sufficient assurance around the controls that we have in place in the areas Ofcom considers relevant to its proposed statement. The BBC Annual Report and Accounts also includes the report and certificate of the Auditor and Comptroller General, which includes his opinion in relation to the risk of the BBC using licence fee money inappropriately to fund commercial activities.[12]

Ofcom's proposed annual separation statement

Given our commitment above, and the existing assurance we provide, we do not consider transparency would be significantly further enhanced by us publishing a further annual statement on operational separation. Ofcom justifies this publication as necessary in 2.15 as it "and other stakeholders have limited visibility of how the BBC is complying with the requirements" and at 2.16 that "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". We consider that both of these concerns would clearly be met by the information we have already put, and are committing to place, in the public domain.

[12] http://downloads.bbc.co.uk/aboutthebbc/insidethebbc/reports/pdf/bbc_annualreport_201718.pdf, p. 178

We have set out our views in 1.1 on our interpretation of the relevance of arm's length in this context. As such we do not consider this is a robust justification for such a publication. We note that similar interventions are implemented for regulatory monopolies with business separation requirements – for example National Grid and BT Openreach. These interventions have been justified on the basis of the significant market power held by one of the relevant entities with a group structure. BBC regulation is based on the need to address the risks of market distortion arising from the BBC's state aid funding, and not on the basis that the BBC has significant market power. As we set out elsewhere, we are concerned about the extent to which Ofcom has fully considered what regulatory requirements should apply in the unique case of the BBC, rather than transposing existing regulation used elsewhere. In this instance we consider that the information we are committing to publishing would be sufficient to address any potential regulatory concerns, specifically noting the overlap between Ofcom's proposed statement on operational separation, and its other proposals around providing greater transparency. For example Ofcom's proposal in 2.17 that the statement on operational separation should include "an account of how the governance of the commercial subsidiaries reflects our requirements…including our requirement for distinct and separate boards…" would be unnecessary given the information we will now publish.

The imposition of a requirement to produce a report and prescribing what measures, controls and processes it must cover in substance amounts to Ofcom specifying the internal operational controls the BBC should have. It is for the BBC Board to ensure compliance with the Charter, Agreement, Operating Framework and the general law[13]. This is a matter of judgment for the BBC based on what it considers is proportionate, practicable and affordable given the regulatory requirements it must meet. If there were evidence that the BBC's judgment in this area was flawed, such that its controls had been demonstrated to be inadequate by frequent upheld complaints and findings of regulatory breaches, it would be appropriate for Ofcom to seek to substitute its judgment to some degree as to the components of the BBC's internal assurance systems and a formal system of reporting of their operation. However, Ofcom has not explained by reference to a clear evidence based rationale why this is necessary in circumstances where such a shortfall does not exist. This is particularly true given the considerable annual effort that would be required for the BBC to prepare and publish such a statement.

4.3 Level of detail to be reported alongside achieved rates of return and in published reports

We note that several of Ofcom's proposals around regulatory financial reporting would require significant additional effort for the BBC to prepare, and for which we do not consider Ofcom has provided a sufficient justification as to why such reporting would be appropriate, specifically:

[13] Article 20(8) of the Charter

- Providing for each line of business revenues, costs, assets, liabilities, capital employed and cash flows in our reporting to Ofcom and published report and accounts
- In reporting to Ofcom at year end, providing details of revenues and costs between each line of business and: the BBC public service, other lines of business in the same commercial subsidiary, other commercial subsidiaries and third parties.

Splitting cash, assets and liabilities by line of business

We do not currently prepare a full cash flow statement or balance sheet for each line of business in our commercial arm. As can be seen from our published Commercial Holdings Financial Statements, we currently consolidate this information at each main commercial subsidiary, not each line of business. The lines of business that we report to Ofcom are not necessarily legal entities. GNL and BBC Studioworks are each one line of business, so correspondingly we are able to provide the relevant information. However, in BBC Studios, the five lines of business do not correspond to the legal structure of BBC Studios Group. We do not currently separate out cash, assets and liabilities by line of business in our reporting, or apportion these in order to manage the BBC Studios business. BBC Studios, while comprising five lines of business for internal and Ofcom reporting purposes, is a single business. As we noted as part of our decision to combine BBC Studios production and distribution in April 2018, there are significant potential synergies from operating this as a single entity.

Management therefore does not ordinarily consider it necessary to disaggregate this information, as it would not assist with running the business. We also note that splitting out assets and liabilities across different lines of business will inevitably require a significant degree of judgement. For example, if an asset is used by both 'International Production' and Content Sales', we would have to decide what proportion to allocate to each. There is unlikely to be an obvious methodology to do this: it could be based on a range of factors including value to each line of business, time spent on each line of business or wear and tear for each line of business. To repeat this exercise for all assets and liabilities would require significant manual effort potentially on an ongoing basis, in addition to changes to current accounting systems and processes, if Ofcom requires this information biannually. Ofcom has not set out in any detail in its consultation document why this further disaggregation of reporting would be necessary, beyond the statements at 5.85 that this would be "important in our work" and 5.89 that the "total revenue and 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". We do not consider this is a robust justification for several reasons:

- As set out in 3.1we do not consider in general it is relevant to Ofcom's regulatory obligation whether or not the BBC hits its targets, as opposed to whether or not we achieve a commercial rate of return. We note the additional range of reporting obligations that Ofcom proposes relate to understanding variance against target rates of return. As set out we consider that, provided we achieve commercial rates of return, there should be limited reporting only around our targets.

- Ofcom has not explained why this information is necessary to identify whether a failure to meet a commercial rate of return for a line of business has occurred or is likely to occur given the BBC is already under a regulatory duty to notify Ofcom if this happens and explain how it proposes to deal with it.
- Ofcom does not appear to have considered the potential additional compliance costs on the BBC to achieve its desired outcome. It is not clear to us exactly what information Ofcom requires in relation to each of our lines of business, which would allow us to propose a more proportionate alternative.

Providing details of revenues and costs between each line of business and: the BBC public service, other lines of business in the same commercial subsidiary, other commercial subsidiaries and third parties.

Ofcom proposes that we report a significant amount of new information to provide details of revenues and costs between each line of business and: the BBC public service, other lines of business in the same commercial subsidiary, other commercial subsidiaries and third parties. Ofcom's rationale for this, as set out in 5.93, is that the "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."

Ofcom has not set out a robust justification for requesting this information; nor has it clearly set out the relevance of the source of revenues or costs to the rate of return calculation, or to its monitoring work. In particular, we fail to see how this information could possibly be meaningful to Ofcom's regulation of the relationship between the BBC public service and commercial activities, in line with the requirements of the Charter and Agreement. The proportion of revenues between internal and external transactions is not an indicator of whether transactions between the BBC and a commercial subsidiary are on terms which could distort the market or create an unfair competitive advantage.

To provide this information would require significant manual effort over and above current reporting. The BBC's commercial subsidiaries do not currently record cost by reference to specific customers, and this is not the market norm. To be required to do so would require significant manual effort on an ongoing basis and involve material changes to current accounting systems and processes, particularly within BBC Studios. We note that this would be in addition to the significant work we have been undertaking to integrate systems and processes in BBC Studios following the bringing together of the BBC's commercial production and distribution divisions in April. It would potentially be more straightforward to break down revenues by source, although this would also require additional manual effort. Noting the lack of a clear rationale for providing this information to Ofcom, it is not immediately obvious to us that this is within the scope of Ofcom's powers and in any event it does not appear to be a proportionate or targeted measure.

4.4 Transfer pricing

4.4.1 Reporting transfer charges each year

Ofcom proposes that we should report to it biannually and publish annually actual transfer charges between each commercial subsidiary and the BBC public service. Ofcom's rationale for this in 5.46 is that reporting "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…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". Ofcom's rationale for publishing as set out in 5.59 would be to "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". We do not consider that Ofcom's proposed reporting obligations aid understanding of the methodologies we use to set transfer prices and how they are applied, which is the target of Ofcom's regulation around transfer pricing.

Specifically, the total value in any given year of intragroup charging gives no relevant information about the methodology used for setting prices, and therefore cannot aid any discussion of its appropriateness. The total charge is based on both the methodology to calculate a price, as well as the usage or consumption of a particular good or service. There are a number of reasons that charges could vary over time unrelated to any change in methodology or price. From the consultation document we do not understand what sorts of 'anomalies' Ofcom expects could arise in these values from year to year that would warrant further investigation, but that would not be picked up by the reporting we already do, and Ofcom proposes to retain, around material changes to transfer pricing methodologies. If the BBC and BBC Studios agreed that BBC Studios would stop using office space in a key location like Bristol, this would impact on the total value of transfer charges for property from one year to the next. However this would not have resulted from any change in methodology, which is where Ofcom regulation rightly focusses. We already publish details of the methodologies we use to set prices, as well as how usage is calculated, which provides the important transparency Ofcom states is necessary. We also report to Ofcom, and publish, details of any material changes to our transfer pricing methodologies. To date we have taken the approach of publishing all of changes we make, including instances where a service is no longer provided. It is unclear what 'anomalies' Ofcom considers it would be able to identify through this proposed requirement to report actual transfer charges that would not be identified by our existing reporting obligations.

With specific reference to Ofcom's proposal that we publish each year the actual transfer charges broken down by service area, we are concerned that Ofcom has not fully considered the implications this would have. In addition to our general point about the total annual charge indicating nothing useful about the methodology itself and whether this is robust, we consider that:

- Ofcom has not set out any robust justification for why we should publish a level of information on the cost base for each of commercial subsidiaries that competitors in the market do not have to publish and would naturally be reluctant to do so. We are concerned that this could provide the BBC's competitors with information that could lead to an unfair competitive advantage over the BBC's commercial arm.
- For certain services it may be possible for third parties to learn of the usage of a particular service (either through information published in the BBC's transfer pricing documents or elsewhere) and to use this calculate details of how prices are set. For example, where BBC Studioworks provides studio space to the BBC there may only be one or two transactions is a given year, so publishing the total charges could amount to publishing the price paid by the BBC. We consider there is a risk that doing so could produce a degree of price transparency which would normally be regarded as detrimental to efficient competition and indeed would be prohibited if competitors exchanged or published such information in a way that could facilitate price alignment.
- Furthermore, some of the BBC's contracts with third party suppliers (e.g. for IT or HR) for group services specifically prevent the BBC from disclosing information about pricing outwith the BBC group. Doing so would risk disclosing what contractors have bid to provide services to the BBC. There is a risk that publishing this information would therefore be anti-competitive. There is also a risk that Ofcom's proposed publishing obligation could, in the short term, require us to balance the risk of regulatory non-compliance with breach of contract and, in the longer term, mean that third party suppliers either do not wish to work with the BBC for fear of information disclosure, or only do so with higher contract prices. Both outcomes would prevent the BBC from being able achieve value for money for licence fee payers, which is a Charter duty for the BBC.

4.4.2 Publishing methodologies of transfer prices for third parties

Ofcom proposes that, as well as publishing the methodologies we use to set transfer prices for goods and services traded within the BBC group, we should do the same for those we provide to third parties. Ofcom notes that this is necessary because they 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 do not agree that there is no transparency around how we charge third parties for the goods and services we also trade internally. Our published Principles for Transfer Pricing sets out that "Where the BBC public service provides a good or service to both the BBC's commercial subsidiaries and to third parties the BBC will use the same methodology and expect to charge the same prices, if the service is comparable."

However, we also agree that our methodology documents on the whole could be more transparent, including about how we treat third parties. We therefore expect to address Ofcom's proposed reporting requirement by combining all the current transfer pricing methodology documents (seven in total) into one transfer pricing methodology statement covering all of the BBC's commercial subsidiaries. Then, for each service, this document would set out which commercial subsidiary (or subsidiaries) a good or service it is provided to, as well as whether it is also provided to third parties. As we take a consistent approach to setting charges, there will be no differences in methodologies.

This would remove a lot of the current duplication in information, given that the pricing methodologies are the same across each of the commercial subsidiaries, as are the majority of services (albeit with some differences for example in the location of BBC property etc.). As such it should be more transparent for our stakeholders, as well as addressing Ofcom's concerns about the lack of transparency over trading between the BBC and third parties.

4.5 BBC Fair Trading Audit

Ofcom notes that it does not "currently have a sufficient understanding of the scope" of our annual independent Fair Trading Audit to "determine whether the assurance it provides is adequate", including "the extent to which we can rely on it". This is incorrect. At Ofcom's request we shared with Ofcom the scope of the Fair Trading Audit for the most recent financial year, as well as the report itself, before we published the opinion in our Annual Report and Accounts. The Fair Trading Audit opinion of the Annual Report and Accounts also provides details of the procedures followed by the auditors.

The BBC's annual independent Fair Trading Audit is a management control for the BBC's Fair Trading Committee, which was setup to assist the Board in complying with Ofcom's trading and separation regulatory requirements[14]. While we publish the auditor's opinion in the BBC Annual Report and Accounts, the purpose of the audit is to assure the Board that the BBC has processes and procedures in place to comply with Ofcom's trading and separation requirements. The BBC Board has a duty to ensure compliance by the BBC with its obligations under the Charter, Agreement, and Ofcom's Operating Framework. We consider the report is an important part of the BBC's control framework, which allows the BBC Board to fulfil this duty, but it would not be appropriate for Ofcom to regulate the audit, or to make the audit a formal part of its regulatory framework.

14 http://downloads.bbc.co.uk/aboutthebbc/insidethebbc/managementstructure/seniormanagement/subcommittee/pdf/bbc_sub_committee_fairtrading.pdf

If Ofcom considers that it requires additional assurance around the compliance procedures the BBC has in place, or seeks greater assurance, we expect that Ofcom would fully consider the potential options available to it. We do not consider that simply having "imposed similar requirements on other stakeholders" is sufficient justification for adding to the regulatory framework for the BBC, as Ofcom seems to propose in the consultation document. We reiterate points made elsewhere in this response about our concern on the extent to which Ofcom has considered regulation for the BBC on its own merits, rather than seeking to transpose regulation it uses elsewhere.

Furthermore, we note that Ofcom's stated rationale for seeking any such assurance would be because "we currently have only limited information to inform any assessment of whether the BBC's pricing is consistent with its methodologies". In this consultation document, Ofcom proposes five regulatory interventions relating to the reporting framework around transfer pricing, including:

- Publication of all actual transfer charges each year
- Biannual report to Ofcom on transfer charges every 6 months
- Biannual reporting to reconcile contracted values in transfer charges against actual charges
- Biannual reporting on any changes to transfer pricing methodologies
- Publication each year of BBC public service income from trading activities

Some of these proposals build on the requirements already in place, which we consider are proportionate. This is in addition to the information we have provided to Ofcom over the past year, which includes further descriptions of how we have set transfer prices in certain areas. Given the number of different regulatory interventions proposed in this document, we do not consider that Ofcom has clearly set out any rationale for the need for it to also take greater assurance via the BBC's Fair Trading Audit.

Finally, the NAO, as part of its regularity and financial audits of the BBC group, reviews in detail the transactions between the BBC public service and the BBC's commercial subsidiaries. Specifically, the Certificate and Report of the Auditor and Comptroller General states "My audit has provided me with reasonable assurance that consolidated income and expenditure is free from any material irregularity. I have been able to take assurance for my audit from the key systems, procedures and controls introduced by the BBC". Specifically in relation to the risk of the BBC using licence fee money inappropriately to fund commercial activities, he noted "I have assessed the design, implementation and effectiveness of the key elements of management's overall governance arrangements, systems, processes and controls. My procedures included attending a meeting of the Fair Trading Committee, reviewing the scope and findings of the external assurance review of Fair Trading, and assessing whether Fair Trading Guidance accords with the framework of authorities. I have also tested a sample of intra-Group transactions between the BBC Public Service Broadcaster (BBC PSB) and its commercial subsidiaries."[15]

Clause 39 of the Charter requires the BBC to appoint the Comptroller and Auditor General to audit the BBC. Clause 40 requires the BBC to ensure that each commercial subsidiary appoints the Comptroller and Auditor General as auditor (or such auditor as has been agreed by the Comptroller and Auditor General). The White Paper stated that "The NAO is uniquely placed to scrutinise public bodies, including the BBC, from a fully independent perspective"[16].

We consider Ofcom has not justified why, or considered whether, the NAO audit may be an effective control on which they can rely. As such, we consider that before Ofcom considers further audit obligations for the BBC it should be able to clearly demonstrate why the NAO's audit opinion is not sufficiently robust for Ofcom's purposes.

[15] http://downloads.bbc.co.uk/aboutthebbc/insidethebbc/reports/pdf/bbc_annualreport_201718.pdf, p.178
[16] DCMS, A BBC for the future: a broadcaster of distinction, May 2016 (https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/524863/DCMS_A_BBC_for_the_future_linked_rev1.pdf) p88

5. Further general points

5.1 Structure of the revised requirements and guidance

In general we welcome and support Ofcom's revisions to the actual requirements and guidance, as set out in Annex 2 to Ofcom's consultation document. We consider that the updated document is clearer than the current requirements and guidance document. However, in several areas we consider that there is a lack of clarity over the role of the guidance. Ofcom's document does not specify the respective roles that the requirements and that the guidance plays. We consider that:

- The requirements are the core "rules" forming part of Ofcom's regulatory framework for the BBC that Ofcom has in place to meet its obligations under Clause 28 of the Agreement.
- Nothing in the Agreement provides for any formal role for the guidance that Ofcom has in place. We interpret that the guidance is therefore to provide additional clarity on how Ofcom will interpret these requirements, and otherwise provide relevant information, but these are not binding requirements on the BBC under the Operating Framework.
- For example, proposed reporting requirement D.2 sets out a range of 'measures, controls and processes' we would be required to report against. However, under the proposed requirements for operational separation, the requirement itself does not specify this level of detail. Ofcom's guidance at A.8 then sets out an expectation that we would have these measures, controls and processes in place. We consider that this is a confusing structure – if Ofcom requires, or proposes to require, that we have each of these elements in place, it should be specified in its requirements not its guidance. This would give us and other stakeholders the opportunity to comment effectively on Ofcom's proposals.

We also note that Ofcom's guidance seems to currently fulfil three different purposes:

- Placing additional requirements on the BBC (e.g. A.8)
- Providing background information (e.g. in B.8)
- Setting out detail on how Ofcom will consider compliance (e.g. C.11)

We would welcome clarification from Ofcom on the role of the requirements and guidance, and ask Ofcom to ensure that each part is then appropriately drafted. We also consider it may be more appropriate to separate out Ofcom's requirements, relevant background information and guidance on Ofcom's approach.

5.2 Implementation period for new requirements

Ofcom's consultation document sets out that "We propose that the modified requirements will take effect from the date of publication of our final decision."

Effectively this would not allow us to have any time to implement any of its revised requirements. This is clearly disproportionate, given the number of changes Ofcom proposes, specifically round reporting, and inconsistent with how Ofcom treats other companies it regulates. We consider that:

- From discussions with Ofcom we expect Ofcom will publish a decision before the end of the 2018 calendar year, probably in December. If all of these proposed obligations then come into force at that point, we would be required to provide Ofcom with our first biannual report, including performance information, by the end of December 2018. This would not be possible, given the time available between Ofcom's decision and our reporting deadlines.
- For annual publication of information, Ofcom's proposals would continue to require us to publish this at the same time as the BBC Annual Report and Accounts each year. This would make the first such deadline under the revised requirements July 2019. Reflecting any of Ofcom's proposed changes that relate to the 2018-19 ARA, including the reports and accounts for the BBC's commercial activities, would be inherently retrospective and therefore disproportionate.
- For information relating to forward looking rates of return, if significant changes are required for what we need to report, this could present challenges for the BBC budget setting process. We expect to have completed the necessary work to set budgets by the end of December 2018 for the 2019-20 BBC budget, including targets for commercial activities. This then goes through the BBC governance process, ultimately to the BBC Board. All of the reporting we provide to Ofcom requires internal assurance and sign-off. If Ofcom requires information (for example the split by assets and liabilities by line of business as is proposed but that we cannot currently provide) this must be reflected in the detailed budgeting work currently underway. However, this will not be possible given no such requirement exists, or will exist until Ofcom concludes its consultation and publishes revised rules which include this change. As such this would require additional effort for us to revisit the budgeting process to produce such information, which would then have to also be reviewed and approved.
- For transfer pricing, any changes we would need to make to our current approach could not be implemented immediately. We set out in 2.3 that we do not generally envisage much change, but we would as a minimum want to review current arrangements for compliance with any new rules, particularly in light of our lack of clarity around cost definitions. As such requiring compliance with immediate effect would be wholly disproportionate.

We note Ofcom's recent consultation on Royal Mail's reporting allowed changes to take effect form the next financial year (i.e. three months between decision and implementation). We consider this is a more proportionate approach, and welcome clarification form Ofcom as to why implementation has not been considered in this consultation.

We propose it would be more proportionate for the following deadlines to implement Ofcom's proposed requirements, on the basis that Ofcom accepts our suggested revisions to its proposed requirements and guidance as set out in this response:

- Changes to any transfer pricing methodologies by April 2019
- Publication of revised transfer pricing methodology statements, alongside the 2018-19 BBC Annual Report and Accounts (i.e. July 2019)
- To report revised forward looking rate of return information, April 2019
- For biannual performance reporting, December 2019 (if Ofcom retains this requirement, which we consider is disproportionate)
- For revised publication of reports and accounts for our commercial activities, alongside the 2018-19 BBC Annual Report and Accounts (i.e. July 2019)

If Ofcom decides to retain its proposed reporting requirements without significant modification, Ofcom must take into account this additional complexity and effort and therefore allow us longer to implement its proposals. We consider that the 2020-21 financial year would be the first year for which we should provide the revised reporting to Ofcom.

We welcome clarification from Ofcom as part of its decision on when our first reporting obligations under the revised requirement would take effect. We also welcome clarification from Ofcom on when its proposed changes to the regulatory framework would take effect.

Annex: Detailed comments on proposed requirements and guidance

Given the extent of the proposed changes, in the tables below we provide comments on the all relevant (i.e. where we have a comment) changes to the requirements and guidance proposed by Ofcom in its consultation, including Ofcom's proposed reporting templates. Where our comments are substantively set out in the main body of our response we do not duplicate but refer to the relevant paragraph(s).

Table 1: BBC Comments on Ofcom's proposed requirements and guidance

Reference	Ofcom's proposed change	BBC comment
Definitions: "Joint Venture"	Definition of joint ventures as being entities in which a commercial subsidiary has a 'material shareholding'	We note that there are accounting definitions of joint ventures under IFRS which relate to degree of control, rather than size of shareholding. We consider it would be more consistent, proportionate and transparent for Ofcom to follow the IFRS definition, given that Ofcom should seek where possible to align our financial reporting with accounting standards and audit requirements. We do not consider it would be desirable to have a definition of joint venture for Ofcom reporting that differs from how we have to report under IFRS.
Definitions: "Commercial Subsidiaries"	Definition refers to the Agreement definition of 'relevant subsidiaries'.	As we set out in 3.3 we consider this should specifically refer to the BBC's *main* commercial subsidiaries. The Agreement definition relates to IFRS accounting standards, and is present in the Agreement for the purposes of setting out criteria around value for money examinations, not in relation to how the BBC should undertake commercial activities. It includes subsidiaries of the BBC that do not carry out commercial activities – such as BBC Childrens' Productions Limited. As such we would propose that Ofcom amends this to clarify this would apply to the BBC's main commercial subsidiaries only, as are named in this definition. We consider that a definition like "Any commercial subsidiary of significant size which undertakes Commercial Activities (as defined in the Agreement)" could clarify this requirement.
A.2, b	'Commercial relationship' has been replaced with 'contract'.	Ofcom has provided no explanation of this change, so we consider that no change is therefore intended. We expect there may be circumstances where it is necessary to share information to fulfil a commercial relationship that may not be strictly covered by a contract (e.g. as part of a negotiation). We would welcome further clarity from Ofcom that this would still be permitted as the specification of contract could inadvertently narrow this definition, noting that contract is not further defined in these requirements.

A.2, c	Permission to share public service information which if shared does not carry any risk of distorting the market	While we welcome this additional clarification and consider it more proportionate than the current requirements, we propose it would be clearer and more in line with standard regulatory practice if this was expressed as a prohibition on sharing information that risks distorting the market. Practically speaking our internal controls framework, which we consider is robust, seeks to identify risks, and to put in place measures to mitigate these risks. It does not set out to prove the absence of risk. We note that Ofcom's discussion in 2.33 endorses this approach, and would welcome this minor clarification to the requirements to reflect this.
A.5	Proposed revisions to add joint ventures to this requirement	We are concerned that the proposed wording of this requirement would require us to report (as set out in D.3) on conflicts of interest identified at boards and/or executive committees that are not part of the BBC group, specifically joint ventures. We note that joint ventures by their nature have shared control; as such it is impossible for the BBC to directly impose requirements on their governance and reporting in the way that we can for a commercial subsidiary where we are the sole shareholder. This would extend to any reporting requirements. We welcome clarification form Ofcom that this proposed revision would only extend to any governance arrangements, and reporting thereon, with the BBC group.
A.9	Examples of areas where information sharing may give rise to market distortion.	As set out in our response in 1.3 we do not consider the Ofcom has substantiated why there is a risk associated with distribution information referenced in this guidance.
A.14	Deletion of the text setting out the potential legitimacy of BBC public service oversight over its commercial subsidiaries.	We agree it is for the BBC Board to structure the governance of the BBC, including its commercial arm. However, we would like further clarity on Ofcom's rationale for the changes in this section, as there is no justification provided as to why Ofcom will not have regard to the legitimate requirement for the BBC to oversee the BBC's commercial activities. We note the points raised in our response at 1.1 about Ofcom's statement that this relationship should be at 'arm's length'.
B.1	Change from 'arm's length commercial terms' to 'at arm's length…and on commercial terms'.	We understand that this change is designed to mirror the wording of the Agreement, and does not constitute a change in approach from Ofcom on what types of arrangements would be necessary. We would welcome clarification from Ofcom as to whether Ofcom considers this constitutes a change and, if so, a robust explanation and justification for the proposal.
B.3, a & B.16-B.17	Simplification of language around defining 'market price'	We welcome Ofcom's simplification and clarification of the mechanisms we could potentially use to determine a 'market price', and consider this a helpful addition to these requirements and guidance. We also agree with the guidance at B.17 which we consider establishes that there are multiple possible types of open market process, not simply formal tender exercises.

B.3, b, i	Proposed requirement to include 'capital costs' and 'an appropriate contribution for reinvestment' within any cost calculation	As we set out in 2.3 we do not consider it appropriate to include an additional 'margin' on goods or services falling in to this category, in part for the reasons we also set out in 2.2 of our response. It would harm consumers, by increasing prices, with no benefit to fair and effective competition.
B.3, b, I; B.3, b, ii & B.4	Various definitions of long run cost for different types of goods and services are now proposed by Ofcom: 'long run costs of provision', 'long run incremental costs', 'direct, long run costs'.	We would welcome clarification from Ofcom that these terms are all used to define different approaches to setting transfer prices, and further clarification of what these differences mean in practice. Specifically we consider that: i. Long run cost of provision intentionally excludes 'capital costs' or 'contribution for reinvestment' because these are goods/services that will not be provided to the market but only within the BBC group. We consider this appropriate, and set out our proposed approach in 2.3. i. Relevant direct, long run costs inclusion of an effective margin is designed to mimic a 'market price'. However, as we set out in 2.2and 2.3 we consider this unnecessary. As such we consider this definition should align with 'long run costs of provision' as we consider Ofcom's intention is to somehow mimic a market price when using a cost based approach. i. Lon run incremental costs would follow the definition that Ofcom uses in transfer pricing arrangements with other companies it regulates (e.g. Royal Mail Group). However, we consider that clarification in this context would be helpful for stakeholders.
B.6, b	Proposed requirement sets out that benchmarking should be reviewed 'regularly in line with market practice'	We would welcome further clarification form on Ofcom on what 'market practice' might mean in this context. We note that the majority of the BBC's commercial peers do not have to perform *regulatory* benchmarking, so it may be problematic to define market practice in this area. We consider that the frequency of any updates to benchmarking may be informed by the type of good or service in question, as well by wider changes in relevant industries.
B.8	Reference to public service as the seller of IT, legal etc. services to the BBC's commercial arm	As set out in our response to 2.3, the BBC, not the BBC public service, is the seller of BBC group (Business) services. We would welcome a clarification thereon in this guidance.
B.11	Clarification on how Ofcom will consider compliance in this area by reference to the 'opportunity cost' to the	We welcome Ofcom's clarification in this area, and agree that 'opportunity cost' is a helpful lens through which to consider transfer pricing. We set out further reasons for our support in 2.3. However, we disagree that a 'hypothetical rational private investor' would not also act strategically. We consider that the strategically best decision for any organisation would also

	public service	likely be the most rational, as strategy is how an investor seeks to achieve its goals, even if that involved charging below cost for access to services in different parts of the group. There would be a number of rational reasons to do this, including allowing new products or services to develop in new markets, or continuing to pursue reputationally important activities that may not be profitable but benefit the business overall. There may therefore be legitimate strategic, and therefore rational, reasons for a private investor to cross subsidise across different legal entities or between different lines of business, provided that doing so does not contravene any legal or regulatory requirements. Ofcom acknowledges this point in its discussions around lines of business, where there is some acceptance that rational investors may act strategically across a portfolio of activities.
B.15, b	Opportunity cost for the BBC brand would be what a third party would be willing to pay to use it	As set out in 2.4 we do not agree. We note that the value of the BBC brand, particularly if used for commercial purposes, is partly a function of work by the BBC's commercial subsidiaries. Any benchmarking of the value of the BBC brand would need to take this into account. The price a third party is willing to pay is determined partly by the value added by the BBC's commercial arm.
B.22	Revised guidance notes that in certain circumstances it may be appropriate to use long run cost rather than market benchmarks, for one off, immaterial transactions	We consider this is a helpful clarification and represents a proportionate approach that will simplify compliance for the BBC with Ofcom's requirements. Given the nature of trading between the BBC and its commercial subsidiaries, where we have in place commercial agreements for all goods and services traded internally, we expect this would be most likely to apply to trading activities (e.g. spare capacity sales) which are more likely to be ad hoc. As we note for proposed requirement D.18, we would welcome further engagement on how to interpret material in this context.
B.23	Guidance on using short run incremental cost, including example for office space	We welcome Ofcom's clarification in this guidance. We consider that to realistically be able to take advantage of such a provision we would require further clarification from Ofcom on the circumstances under which it may and may not be acceptable to set prices on such a basis. Office space, the example Ofcom cites, is illustrative, given the wider considerations we must take into account in setting charges. As set out in our published transfer pricing methodologies, the BBC provides office space to its commercial subsidiaries based on market price. We also mirror this approach with third parties to ensure we are consistent, in line with Ofcom's requirements that we treat commercial subsidiaries and third parties equally. If we offered office space to a third party based on short run cost only – even if this was on a 'last minute' or 'spare

		capacity' basis - we would not be treating parties consistently. However, as Ofcom notes, this is an instance where doing so may be in line with market practice. As such, we would welcome further clarity from Ofcom about the interplay between these different regulatory obligations – on the one hand to follow market practice, and on the other to ensure consistency. There are circumstances under which allowing flexibility to 'follow the market' would be advantageous to ensure the greatest possible use of BBC assets, and therefore to secure value for money for licence fee payers. However, given our regulatory obligations, and the need for us to have in place a robust compliance framework, it may be challenging to allow much flexibility in setting prices. Production facilities in the Nations and Regions is another illustrative example – the BBC provides these to both BBC Studios and third parties for BBC productions. We have in place a service level agreement for BBC Studios, which sets out charges. This is updated each year. These charges reflect market prices, based on benchmarking. However, the SLA has a rigid pricing structure to ensure that we have effective oversight over transfer pricing and can therefore comply with Ofcom regulation. The market for production facilities is more dynamic than this – a rational commercial operator could take a number of approaches to charging, including using short-run incremental cost under certain circumstances. However, practically speaking we do not consider this is a realistic option for the BBC, given our regulatory obligations and the evidential bar necessary to satisfy ourselves that we meet these. If we allowed BBC Studios to use these facilities based on short run cost, a third party may have some legitimate grounds to complain about our approach to transfer pricing. While we expect to continue with our current approach, we would welcome further clarification from, or engagement with, Ofcom to explore what approaches with more flexibility may be possible under Ofcom's regulatory framework.
B.28	Ofcom notes that we can set prices higher than cost/market benchmark, if we wish, for services provided from the BBC to its commercial subsidiaries	We welcome this clarification and the potential flexibility it would allow the BBC. We consider this is more targeted that the current approach to Ofcom's theory of harm that there could be some form of cross subsidy However we would expect that were we to set such charges on a basis other than costs or market price this could affect the rates of return that our commercial subsidiaries can target or achieve. We would welcome clarification from Ofcom that this would be acceptable and would be taken into account by Ofcom in its monitoring work around rates of return.
B.30	Clarification that Ofcom's	We have set out in 2.1 this is a welcome clarification which reflects BBC current practice.

	rules on transfer pricing apply to transactions from a commercial subsidiary to the BBC public service	However we also note our desire to better understand what possible evidence we could use to satisfy ourselves of this information. We do not consider it would be appropriate for Ofcom's regulatory framework to result in outcomes where the BBC is incentivised to not do business with its commercial subsidiaries in the markets in which they operate, which is a risk of Ofcom's proposed approach.
C.2	Revised requirements note that the BBC should 'assess and set an appropriate commercial rate of return'	As set out in 3.1 we consider that a commercial rate of return should refer to the market norm for a particularly subsidiary or line of business. There is a fundamental difference between our commercial targets and a commercial rate of return, which we consider Ofcom needs to acknowledge in its regulatory framework to ensure this aligns with the obligations on Ofcom and the BBC under the Charter and Agreement.
C4, b	Added requirement to inform Ofcom of changes to any of the lines of business in the BBC's commercial arm	We consider that this revised requirement is justified based on Ofcom's stated need to understand the lines of business in the BBC's commercial arm and how these change, and that it effectively replaces the existing requirement which could appear unnecessarily 'static'. However, we would welcome clarification that this relates to a change to the composition of the line of business (i.e. the commercial activities it comprises), which we consider is Ofcom's intention. We would also welcome clarification from Ofcom that any reporting required under this proposed requirement would be subject to the materiality provisions Ofcom proposes in D.18. The BBC's commercial subsidiaries operate in dynamic and fast changing markets, which means their business operations must also respond to these market conditions. We consider it would be disproportionate to have to report all changes to Ofcom, when minor changes (like investment in different activities) would not alter the fundamental composition of a line of business.
C.11	Added guidance around how Ofcom would approach potential enforcement procedures	We welcome Ofcom's clarification around the links between the BBC's commercial activities and its public service remit. We note that we only undertake commercial activities to return additional revenue back to the BBC, not as an end in itself. As such we consider it imperative to ensure that in operating our commercial activities we do not negatively impact on the public service.
D.1	Proposed requirement that we publish details of BBC income from trading activities	This information is already provided in the BBC Annual Report and Accounts (Table A1 on page 190 of the 2017-18 Annual Report) 'BBC income from trading activities', broken down by royalties, rental Income, Inter-group trading and other revenue. We note that Ofcom refers to these categories specifically in this requirement. We are happy to commit to continue to provide this information.

D.2	Proposed requirement for us to publish each year an operational separation statement	As set out in 4.2 we do not consider this proposed requirement to be proportionate given the minimal risk or potential harm that Ofcom is able to substantiate in its consultation document, as well as the information we are committing to publish and the assurance stakeholders already have on separation. We also note that Ofcom's reporting proposals in this area would require us to report against several areas (e.g. 'appropriate arrangements for colocated employees) that are not specified in Ofcom's requirements, but in its guidance. As we consider the guidance part of this document is in general a description of how Ofcom will interpret its requirements, it is unclear to us what justification Ofcom then has for imposing reporting requirements that do not reflect our actual regulatory obligations (i.e. Ofcom's proposed requirements). We consider that this approach risks undermining transparency in the overall regulatory regime – if Ofcom considers the areas in D.2, e to be requirements from a reporting perspective, then clearly these are intended to be set as requirements, not guidance, and we would expect Ofcom to consult on these changes as such, rather than as a reporting and transparency obligation. We would welcome clarification from Ofcom on this point, noting specifically that Ofcom's current regulatory framework is in effect principles based. For the avoidance of doubt we also consider that for Ofcom to impose any regulatory requirements around the measures set out in D.2, e would also be disproportionate to the harm Ofcom is seeking to prevent.
D.4	Proposed requirement for us to publish specified information on the governance of the BBC's commercial arm	We set out in 4.2 the information we commit to publishing which would meet this requirement. As we will continue to publish this information, we have no reservations with Ofcom changing its regulatory framework to reflect this. We agree that this transparency will benefit stakeholders in understanding how the BBC's commercial activities' governance works.
D.5, a & D.5, d	Requirement refers to publishing methodologies for 'that Financial Year'	We consider that, as currently drafted, this requirement would be lagging, not leading. Based on the use of 'that Financial Year' elsewhere in these proposed requirements, we interpret that this would refer to the previous financial year. So for a hypothetical publication in July 2019, the methodologies we would publish would be for the previous financial year (2018/19). We welcome clarification from Ofcom as to whether this is its intention. We note that we currently publish transfer pricing methodologies for the current financial year (i.e. those on our website currently are for the 2018/19 financial year). So this requirement would mean that we publish these again next year. Each year, before the start of the financial year, we

		update all transfer prices and commercial agreements for services that are expected to be provided inside the BBC group. We do this to ensure that the BBC and its commercial subsidiaries are able to budget appropriately for the coming year, but also to ensure we have oversight over transfer pricing. This then allows us to meet Ofcom's current publishing requirement with accurate information. We consider it more transparent to publish these for the financial year to which they apply, as this would give Ofcom, or another stakeholder, an opportunity to raise a hypothetical concern with any methodology in a timely manner, potentially preventing any hypothetical harm, or minimising its impact, which we consider would be Ofcom's aim to prevent potential market distortion. To publish out of date pricing methodologies would likely make such intervention more difficult.
D.5, a, iii	Proposed requirement to publish pricing methodologies for services the BBC sells to third parties	We set out further details of how we would propose to provide this information in 4.4.2. We do not consider it would be proportionate for us to publish methodologies for all services provided to third parties that are not also provided to commercial subsidiaries. A number of such services are provided on an ad hoc basis – e.g. multiplex capacity – on the basis of spare capacity in the BBC. This is in line with Ofcom's requirements, and those set out in the Charter, around permissible trading activities. As we set out in 2.2 Ofcom's theories of harm in this area should chiefly relate to market distortion or unfair competitive advantage by the BBC's commercial subsidiaries, as the BBC is not a monopolist in providing goods and services to third parties. As such we do not consider that transparency is enhanced by requiring us to publish pricing methodologies for goods and services not traded between the BBC and its commercial subsidies, which would therefore be disproportionate under the circumstances.
D.5, b	Requirement to publish details of all changes made to transfer pricing methodologies	We are concerned about the removal of 'material' from this requirement, which Ofcom has neither described nor justified in its consultation document. We consider that while a materiality threshold could be deemed to apply to this clause in line with proposed requirement D.18 (which would mirror the current requirement), this would leave the requirement itself ambiguous given that it relates to 'all changes' not simply to 'changes'. We would welcome clarification from Ofcom as to whether this is intended to be a change, and if so on what justification. We do not consider it would be propionate to report all changes to Ofcom, which we understand is the basis for Ofcom's proposed requirement D.18.
D.5, c	Requirement to publish actual transfer changes by service area	As set out in our response to 4.4.1 we do not consider this requirement would aid understanding of the methodologies used to set transfer prices, which is the focus of Ofcom's regulation, and risks breaching commercial confidentiality.

D.6, a	Requirements to provide Ofcom with details of total transfer charges, dividends and loans	We consider that this requirement is unnecessarily duplicative, specifically in the context of Ofcom's further proposals set out in this document. In proposed requirement D.7 Ofcom proposes that we report details of transfer prices; the BBC Annual Report and Account sets out details of dividends paid by commercial subsidiaries. No loans are provided within the BBC group – both the BBC and its commercial subsidiaries have borrowing limits set by the Secretary of State and therefore funds are raised separately.
D.7, a	Requirement to notify Ofcom of all changes made to transfer pricing methodologies	As set out in our comments on D.5.b, we are concerned about the removal of 'material' from this requirement, which Ofcom has neither described nor justified in its consultation document.
D.7, b	Requirement to report actual transfer charges by service area	As set out in our response to 4.4.1 we do not consider this requirement would aid understanding of the methodologies used to set transfer prices, and therefore would not assist Ofcom in discharging its obligations. We also consider that Ofcom's proposal that we report contracted values as well as actuals would similarly not provide any meaningful information. For certain services, like legal, there is likely to be no contracted value, as these are used 'when required'. Any reconciliation in this instance would not aid understanding of the methodology used. What matters to preventing market distortion is that we use an appropriate methodology to set the transfer prices, not whether or not actual charges correspond to what is contracted, which can have a number of a explanations with the most likely being a subsidiary has changed its use of a particular service is used. We note that Ofcom separately requires that we report any changes to transfer pricing methodologies, which would allow Ofcom to monitor any changes to methodologies that could give rise to a concern. Finally, we consider that any requirement to report information relating to previous years would be retrospective. If we were to provide this information on an annual basis to Ofcom, we do not consider there is any justification for reporting information for previous years, except in the first year of reporting, in which case it would require us to report information relating to year for which this requirement did not apply. We request that Ofcom considers further whether this is a proportionate regulatory intervention.

D.8 & D.13	Specification on the frequency of reporting information to Ofcom	As set out in 4.1 we do not consider that this frequency of reporting is proportionate or necessary for Ofcom to discharge its obligations in regulating the BBC. We consider we should only be required to report annually, at the same time as we publish our Annual Report and Accounts.
D.9, b, ii; D.10, c & D.13, a & c	Requirement to provide revenues, costs, assets liabilities, capital employed and cash flows at the level of line of business	As set out in 4.3 we do not currently record information at this level of detail at the level of line of business within BBC Studios. This level of detail is not necessary to exercise effective management control over BBC Studios, noting that it is ultimately run as a single commercial subsidiary. Reporting by line of business is an Ofcom requirement, that does not necessarily align with legal structures within BBC Studios, and therefore with standard accounting practice. As such we do not consider that Ofcom has provided a robust justification of why this level of detail in reporting would be necessary, particularly in light of the additional effort involved in producing this information. This then gives rise to Ofcom's further reporting requirement at D.9, b, iii to then reconcile the results by line of business and details thereon back out our statutory accounts, which is only necessary where Ofcom requires such detailed reporting at the level of each line of business.
D.11	Requirement to provide information for all future years for which we have prepared budgets and/or business plans	We note Ofcom's intention under this proposed requirement would be for us to provide data looking further ahead than the next financial year. As set out in 3.2 we only prepare full budgets for the next financial year, and consider that is what we should report to Ofcom in the absence of any projected failure to make a commercial rate of return. We also do not consider the drafting of this proposed requirement is sufficiently clear to achieve Ofcom's stated intention – "budgets and/or business plans" could be satisfied by us providing budgeted data, business plan data, or both. Nothing in this clause as currently drafted clarifies what Ofcom thinks is relevant for reporting purposes. We note that Ofcom's current requirements place an obligation on the BBC to provide business plan information only in the event that we fail to make (or expect to make) a commercial rate of return. We consider this approach more proportionate.
D.13, d	Requirement to break down information on revenues and cost by each line of business for transactions with other commercial subsidiaries, other lines of business etc.	As set out in 4.3 this information would be difficult for the BBC to produce, and would require changes to existing accounting systems and process. We do not consider that Ofcom's stated rationale for this requirement is sufficiently robust to justify this level of additional effort.

D.15	Proposed requirement for us to report to Ofcom if we fail to meet our target rates of return	As set out in 3.1 we consider Ofcom has conflated two distinct concepts of our target rates of return and commercial rates of return. Only for a failure to achieve the latter should we be required to provide any additional reporting to Ofcom, to allow Ofcom to effectively fulfil its duties.
D.17	Requirement to provide information for the BBC's commercial subsidiaries as well as any of their joint ventures	As we set out in our comment on requirement A.5, we are concerned that the proposed wording of this requirement would require us to report from joint ventures which by their nature have shared control. With respect to financial reporting this is possible; with respect to reporting on separation this could be problematic given the nature of shared control. We welcome clarification from Ofcom that this proposed requirement would only extend to information concerning the joint venture from the BBC's perspective, rather than requiring any reporting from the joint ventures themselves.
D.18	Requirement to only report 'material items'	We welcome this clarification, noting that the absence of a current threshold for reporting risks placing disproportionate requirements on the BBC, without being of any benefit to stakeholders. We welcome the opportunity to further clarify with Ofcom what a reasonable approach would be to implementing this requirement, given the absence of a clear definition of material in this context. We note that the National Audit Office has set a materiality threshold for the BBC group of c.£25m for financial audit, which would unlikely to be appropriate for Ofcom in this context. We consider that it would be most appropriate for the BBC to use different thresholds for each commercial subsidiary or line of business, noting that each of these is on a different scale.

Table 2: BBC Comments on Ofcom's proposed reporting templates

Template	BBC Comment
Template 1	We would only expect to use this template for material changes to any pricing methodologies. However, we do not consider that in all instances it would be practical, or possible, to set out the £value impact of any such changes. For services based on usage, some of which may only rarely be used, this may not be possible or useful (i.e. the actual value for impact may be £0 if we cannot or do not forecast usage). In setting out any information in this template we would need to also set out a counterfactual for usage the service, which cannot be done through this template. Ofcom's trading and separation rules do not extend to how much of any good or service the BBC should trade with any of its commercial subsidiaries, but only to the pricing methodology. We also do not consider it therefore aids transparency for wider stakeholders. As we expect any reporting under this template to be relatively rare, it may be more proportionate to provide the necessary information on a case by case basis to Ofcom rather than rely too heavily on this template, given its limitations.
Templates 2, 3 & 4	We expect that, if Ofcom decides to implement this requirement, we would expect any half yearly report would be a full year forecast only, with actuals then reported and published after year end. We would expect the third part of the table, which seeks comparative information, would only be necessary to complete from the year after this requirement comes into force. We do not consider it relevant in all instances to include the 'contracted' values within this - as set out in our response and above, charges depend on usage as well as pricing methodology, with changes in usage being the driver of any change in actual against a contracted value, unless a material change to a methodology takes place. In some instances the contracted value will be nothing, for example with ad hoc services. This may create an inherent variance in our reporting that we then have to explain to Ofcom, but that would not indicate anything about the pricing methodology. We consider this disproportionate to any harm that Ofcom is seeking to prevent, noting the separate requirement to report any material changes. We would welcome clarification from Ofcom on whether 'paid' would be as at the reporting date (31March) as, if so, then Q4 bills would be outstanding, as these are billed in March. If paid would be by the date of submission, then these bills might be settled.
Template 5	We note the potential overlap with Ofcom's proposals under templates 2, 3 and 4, as we set out in Table 1. The funding elements of this are separately reported: we have trading intercompany balances and separate funding balances, Ofcom should only be interested in the former as the latter is disclosed in the year end accounts. We also do not look at a gross position on services in and services out, we make a payment that nets off the two, so it would be simpler to have a net of the transfer charges in/out and similarly just one payments column.

	We also consider that agency transactions, which do not represent transfer pricing, may form part of this reconciliation but cannot be easily identified. If group tax relief is material then we may need to split this out in a further column. We also consider that this template may not align with our statutory accounts, as this does not show trade between commercial subsidiaries, which further complicates any potential reconciliation between Ofcom reporting and statutory accounts.
Template 6	Line of business is the lowest level that the BBC Studios executive committee looks at performance – content sales, for example, is not further segmented, so there would be no “revenue stream 1”, “cost stream 1” etc. We do not consider that Ofcom should require more granular information than the BBC considers necessary to run each commercial subsidiary and line of business. We reiterate that cashflow, assets and liabilities are problematic to report as it is a real allocation basis as the balance sheet and cashflow is not held on a line of business basis, instead being by statutory entity without a line of business split. Splitting assets and liabilities within the year is also problematic as asset value will be influenced by decisions on carrying value only taken at year end.
Templates 7 & 8	As we note in our response, splitting revenue by customer/area within each line of business is possible, although would require manual effort, but costs are not – they are not mapped to specific customers and it would be disproportionate to start doing an allocation process for them. This would be a resource intensive, new exercise and we consider that the theoretical answer at the end of it would be meaningless for BBC Studios as a business, or the BBC.