

Submission to Ofcom's consultation on the
BBC's commercial activities

pact.

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Executive summary

Pact welcomes the opportunity to contribute to Ofcom's consultation on the BBC's commercial activities.

The agreement reached between Pact and the BBC in December 2015 on BBC Studios sets out the basis on which Pact has been willing to give its in-principle support to the creation of Studios. The key points in this agreement have since been endorsed by both Government and the BBC Trust. We strongly believe that the principles must be implemented and that the agreement can be applied to assess and oversee other BBC commercial activities.

The principles that Pact and the BBC agreed include:

- no direct or indirect cross-subsidy;
- demonstrable separation between the finances and operations of BBC public service and BBC Studios;
- arm's length commissioning;
- fair transfer pricing and fair and transparent competition for new commissions between BBC Studios and third party producers.

In general we support the requirements that Ofcom has set out in this consultation. We are pleased to see robust requirements under the supply of goods and services and transfer pricing sections and endorse these requirements especially where Ofcom has outlined procedures on how to deal with exceptions.

However there are some areas in which Pact would like Ofcom to reconsider and amend when finalising the requirements in order to provide greater transparency and clarity to licence fee payers and others in the market about the BBC's commercial activities.

Firstly Ofcom has acknowledged its role to 'consider whether' a review of BBC Studios is appropriate. Pact reminds Ofcom that the outgoing BBC Trust recommended as part of its final judgement on approving BBC Studios that 'Ofcom reviews the arrangements in two years' time to ensure they are operating as intended'.¹ Given this endorsement we urge Ofcom to agree to an early review of BBC Studios, within the first 2 years: we would hope that early involvement at the design stage will be more effective than retro-active correction of any non-compliant arrangements.

Secondly we seek assurances from Ofcom that it will carry out a comprehensive review of transfer pricing arrangements within the next year in order to establish a system that can command confidence in the market and diminish the potential for complaints. We continue to be concerned about this because last year's Ernst and

¹ Regulatory decision on BBC Studios, p48 20 December 2016

Young review on the BBC's Transfer Pricing regime identified a number of risks and areas for improvement, including 'materiality thresholds', consistency of approaches and triggers for central referral. Given the importance of this area – which has historically been largely self-policed by the BBC – and in particular due to the creation of BBC Studios as a major new commercial subsidiary - Ofcom should conduct its promised detailed review of transfer pricing arrangements sooner rather than later.

A particular focus of both Ofcom's BBC Studios review and its review of transfer pricing arrangements should be the relationship between the BBC, BBC Studios and BBC Worldwide in terms of acquisition of distribution rights. Absolute transparency is important to give the wider market assurance that BBC Studios is not receiving any direct or indirect subsidy in this area. BBC Worldwide has in the past enjoyed a 'first look' to acquire distribution rights in BBC content, secured by a substantial advance. If such arrangements are to be continued, they must not only be at market rate, they must be seen to be at market rate. Otherwise BBC Studios may be accused of benefitting from an effective subsidy allowing it to operate at lower production margins than its (new) competitors in the market. It is acknowledged that commercial confidentiality constraints inhibit public disclosure of the detail of such arrangements, which is why Ofcom is best placed to provide the market with such assurance. Early assessment of this area will enable Ofcom to demonstrate with transparency that there is no risk of market distortion – in a market recently fundamentally altered by the creation of BBC Studios – as required of it by Clause 28 of the Agreement.

We also call on Ofcom to publish the arrangements for managing potential conflicts of interest within the BBC. Particularly where directors serve on boards of both commercial and public service arms and for it to direct the BBC to ensure the majority of directors who serve on these boards are separated from BBC public service.

Pact understands the important role which the BBC plays in the UK broadcasting ecology. A strong properly funded BBC is incredibly important to the UK production sector.

Pact supports the BBC's ambition to become more competitive and believes the opening up of competition, as signalled in the renewed Charter, will play a fundamental role in further stimulating the broader UK production sector. BBC Studios will of course play its part in this move to 100% contestability but it must do so through proper functional separation and with no direct or indirect cross-subsidy. Therefore the rules governing these entities and the relationships between the BBC and its commercial subsidiaries as well as between each BBC commercial subsidiary

must be properly robust and command the confidence of the market, stakeholders and the wider public.

Introduction

1. Pact is the UK trade association which represents and promotes the commercial interests of independent feature film, television, digital, children's and animation media companies.
2. The UK independent television sector is one of the biggest in the world. Despite the difficult economic climate, independent television sector revenues have grown to around £3 billion in 2015.²
3. In 2015, the BBC spent £443 million on commissions from UK external producers. Last year, the BBC commissioned 46% of eligible television content from external producers³.
4. BBC Commissions are important for independent producers as they account for 29% of all UK commissions, making the BBC the biggest buyer of content made by independent producers in the UK.⁴
5. Pact recognises the important role that the BBC plays in the UK television marketplace and how it nurtures and adds to the finely balanced TV production ecology in the UK. We are pleased by the positive trajectory of the new charter whereby the license fee has been secured for another 11 years. The BBC is a positive innovator and experimenter in the marketplace and this is often driven by the content which it commissions from independent production companies.

² Pact Census 2016

³ BBC Annual Report 2015/16

⁴ Pact Census 2015

Section three: Trading and separation requirements

1. Separate subsidiary

1.1 Pact supports the rationale for permitting the BBC to participate in commercial activities through its commercial subsidiaries provided that any profits generated are used to supplement the BBC's investment in creating public service content and are aligned to its public mission and purposes. Furthermore, as noted by Ofcom these activities should not create market distortion and Pact calls for these commercial subsidiaries to adhere to legitimate commercial behaviours. Pact has previously raised concerns that these requirements are only applicable to BBC commercial activities within the UK market. Pact would like to highlight that there could be issues arising from commercial activity in the international markets that may have a detrimental effect on the proper functioning of UK markets (e.g. where BBC commercial activities impact on the international operations of other UK-based players, or where there are concerns that BBC Worldwide has secured international rights that were not made properly available to commercial third parties). In these cases we'd like clarification that Ofcom will also consider complaints under those or similar circumstances.

1.2 BBC Worldwide has four main business activities – programme sales and distribution, consumer products, channels and production. As highlighted by O&O in their report on the BBC as a publisher/broadcaster, since 2004, when the Terms of Trade were introduced, and just before the introduction of the WoCC, BBC Worldwide sales have grown by 70% and gross profit by 93%, even though BBC in-house content as a share of all BBC commissions has fallen by 40% over the same period. Investment in content has only had to increase by 15% compared with 2004.⁵

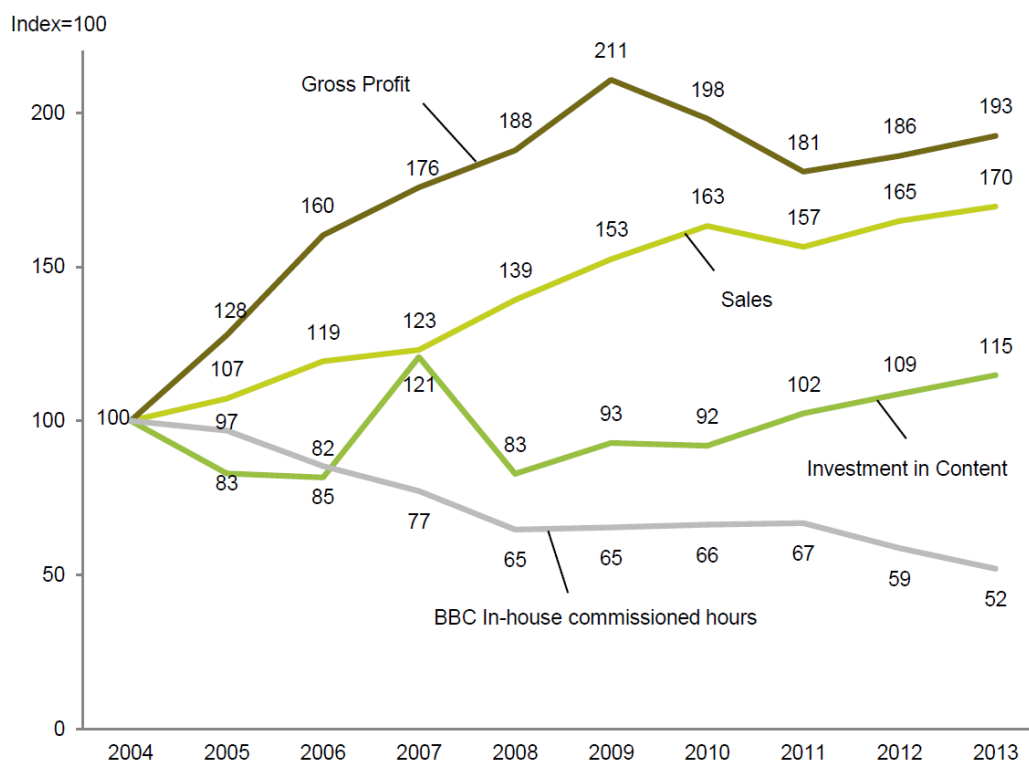
1.3 Although some of the sales and gross profit growth is due to acquisitions and changes in group accounting for joint ventures, there has been strong growth in individual organic revenue streams such as programme sales and distribution which has increased from £167m in 2004 to £310m in 2013.

1.4 One of the trends identified by O&O, as shown in the chart below, is that BBC Worldwide has increased the amount in which it invests in content in recent years. Whilst this provides an important boost to the UK production sector, it is

⁵ A new age for UK TV content creation and a new role for the BBC, O&O report for Pact, August 2014

also important that the maximum value is returned from BBC Worldwide back to the BBC public entity to ensure investment in original content.

Figure 1: BBC Worldwide key financial indicators and BBC in-house commissioned hours, index 2004=100



Note: excluding News and sports
 Source: Attentional, BBC Worldwide, Oliver & Ohlbaum analysis

Source: O&O report

1.5 Looking at the detail of this chart, it is clear that BBC Worldwide has successfully increased its television sales over the last 10 years. It is therefore interesting to note that the company’s profits are not significantly higher than they were in 2008, despite sales having risen steadily during this period. Pact believes a steady sales increase would normally correlate with increased profits rather than a profit rate that is unchanged. Pact questions whether this might be because BBC Worldwide is using the profitable sales part of the business in order to fund less profitable areas, such as its channels business. If this is the case, this is a concern as a reduction in BBC Worldwide profits means it will not be able to return the highest possible dividend back to the BBC. Due to the fact that historically it has been impossible to properly assess or interrogate BBC Worldwide’s accounts it could also be the case that the modest increase in BBC Worldwide’s over all profits is camouflaging loss leading investments in programme rights either for the BBC or third party producers. If this were to be the case then it would be possible for BBC Worldwide to advance large amounts of investment to BBC Studios through first look out put deals to secure rights or

undercut commercial third parties prices in order to secure share for its own non UK channels businesses or to gain share of the UK market.

- 1.6 Pact therefore believes there is a need for Ofcom to maintain some flexibility on investigating the impact of the BBC's commercial activities in international markets and have the ability to check how profits from BBC Worldwide are returned back to the BBC and that they are being appropriately maximised. According to figures cited in the BBC's annual report, last year BBC Worldwide returned £222m, to the BBC in the form of a dividend.⁶ However it is not clear how this contributes to BBC content investment.
- 1.7 It is particularly important for our members to have faith in the role and duties of the regulator because the BBC has such an impact in the UK market. For example BBC Studios will start with a market share of just under 21% this is larger than any of the largest productions companies that we represent.⁷ Despite consolidation in the market, none of the large independent production groups has managed to aggregate more than 15% of annual output hours across multiple UK broadcasters⁸. Given this considerable advantage it is important that there is no cross subsidy – whether direct or indirect and that there is rigorous separation between BBC public service and the commercial subsidiaries. We acknowledge that the BBC confirmed in the 4CC main proposal on BBC Studios that the BBC Studio's relationship 'will not be exclusive and (as today) BBC Studios will be able to work with third party distributors where it decides this is the best way to drive returns. Similarly, BBC Worldwide will continue to work with independent producers just as it does today.'⁹ This is welcome but given the close links which both commercial subsidiaries would have with the BBC public entity, this statement does not alleviate concerns that two commercial companies, operating under the BBC Brand, could collude to undercut the market and inflate market rates on talent etc. without any regulatory oversight or transparency.

2. Operational separation requirements

- 2.1 We agree with the operational separation issues identified in the consultation document. Foremost commercial subsidiaries should not have privileged access to information, except where required for a specific and justified purpose (which should be in exceptional circumstances only). More information and clarity on how Ofcom will ensure that any information sharing does not give BBC Studios and other BBC commercial subsidiaries an unfair advantage in the market is necessary. Furthermore we believe it is in Ofcom's place to propose and publish what these mechanisms might look like.

⁶ BBC Annual report 2016

⁷ Oliver and Ohlbaum Associates, Consolidation, globalisation and vertical integration – myths and realities, March 2015

⁸ IBID

⁹ BBC submission to the BBC Trust 4CC process for BBC Studios, Sept 2016

2.2 Pact is concerned that any overlap of board membership between BBC Studios and the BBC Board – or other parts of BBC public service – presents significant risks of conflict of interest and/or privileged access to information for BBC Studios. Our preference is for no overlap. However we recognise that BBC may not consider this practicable. Therefore Ofcom should stipulate that the overwhelming majority of commercial directors must be separate from the BBC's public services. Without a clear steer set by Ofcom, there will not be sufficient operational separation between the BBC unitary board and the commercial services, making the service open to critique from external organisations in the market. We agree that robust measures must be in place to address any potential conflicts of interest arising from such situations. These measures should be published in order to give third parties confidence that conflicts are being appropriately managed. When the BBC has faced a change of regulator in the past the BBC and regulator have tended towards maintaining the status quo. The new structure Ofcom is establishing presents the opportunity for Ofcom to be clear on its ability to implement a strong and robust enforcement regime.

2.3 We are concerned that the status quo and a regime inherited from the BBC Trust could be maintained and the BBC could be allowed to overlook commercial efficiency and good governance in order to support its broader strategic objectives. In Tony Hall's recent speech (January 2017) he outlined his priorities for the BBC to be more ambitious globally and that there is no other option but for BBC Studios to succeed.¹⁰ Given this priority Pact is concerned that this focus could influence proper commercial behaviours. For example with board overlap and a lack of separation between commercial and public service directors there could be commercial choices made in order to support BBC Studios. Therefore a key element for us will be to what extent Ofcom and the BBC will allow BBC Studios to fail or succeed like any other commercial entity. We have no issue with BBC Studios becoming a successful commercial entity but want this to be achieved fairly and transparently.

3. Supply of goods and services and transfer pricing

3.1. We support the robust requirements set out under this section and endorse the basic principles of transfer pricing and how Ofcom expects the prices to be calculated. We particularly welcome the clearer guidelines on how the hierarchy of various pricing methods will be used. This includes the transparency on pricing by requiring the BBC to publish specific methodologies used for pricing each type of goods and services, including how BBC brands are valued. That

¹⁰ Speech by Tony Hall, Director-General of the BBC, to BBC staff in Birmingham on 11 January 2017.

said we urge for Ofcom to go further and require a range of prices to be published to allow an even greater visibility over the system.

- 3.2.** Pact also agrees with the clearer exceptions process set out including when a cost based approach will be used. We welcome the requirement that the BBC must ensure any cost based approach covers all direct costs, relevant contribution to overhead, capital costs and an appropriate contribution for reinvestment in the public service activities. This will help the BBC's commercial subsidiaries to adhere to normal commercial behaviours.
- 3.3.** However, how this will be implemented in practice will be another matter. We continue to remain concerned about the lack of transparency in current transfer pricing arrangements and note that the recent review by Ernst & Young¹¹(EY) – which looked only at a small sample – identified a number of risks and areas for improvement, including around consistency of approaches and triggers for central referral.
- 3.4.** Following this review the BBC was given the opportunity to modify its practices ahead of the market having the opportunity to comment on its practices. The effectiveness of the BBC's transfer pricing regime – both in principle and in practice – is a matter of significant concern to the market and it does not seem right to deny third parties the opportunity to express views on proposed actions before they were finalised. For example in one area recommended for improvement by EY (on benchmarking) the BBC Trust was asked to publish more detailed guidance on what is considered a 'margin' this will not be published until April 2017; this was much too late for us and other third parties to review ahead of the approval for BBC Studios.
- 3.5.** We also continue to be concerned about the actions the BBC may or may not be taking prior to BBC Studios becoming a commercialised subsidiary with regards to the pricing and terms of existing contracts for co-production and co-development deals. We would expect the transfer of existing programme contracts and consequent recharging tariffs to be consistent with market norms i.e. the costs of a productions plus a margin. We believe an early review of BBC Studios and the transfer pricing arrangements will help understand any issues that might occur. Although the BBC Trust approved the regulatory proposal for BBC Studios it acknowledged that all future commissioning decisions between BBC Studios and the BBC public service would be subject to Studios implementing organisational structure effectively and adhering to the rules of operation. It also acknowledged that checks should be put in place to make sure

¹¹ BBC Transfer Pricing Review, Ernst and Young, August 2016

that any commissioning decisions are in line with market practice and designed in a way that adheres to state aid rules.¹² For this reason we call on Ofcom to confirm that it will carry out a comprehensive review of Studios which includes the period just prior to Studios becoming commercialised.

- 3.6.** We look to the BBC and Ofcom for a clear commitment that findings from any future audits and other internal reviews will be made public to ensure interested third parties are made aware of any specific issues which arise and proposed actions to address them. A world class standard of transparency is critical to sustaining the confidence of external stakeholders in the BBC's transfer pricing and wider fair trading arrangements.
- 3.7.** It is especially important to make sure there is no subsidising of activity via any BBC commercial subsidiaries' use of BBC group services. This could mean that the BBC Studios could under cut the market by taking advantage of lower prices offered by BBC Group which could allow the BBC commercial subsidiary to charge below market rate in its products.
- 3.8.** The BBC Commercial subsidiaries must pay the market rate for any goods or services it uses and these must be benchmarked against comparable market rates. It should be subject to the same cost control and decision making as any commercial entity especially if the BBC commercial subsidiaries are to adopt normal commercial behaviours. This includes how it would account for the set up costs of BBC Studios in the accounting procedures. We acknowledge that Studios will be an asset light entity but the fact that there will be a transfer of existing contracts and development activity means that it puts BBC Studios at a considerable advantage compared to other commercial competitors and further justifies the call for checks and balances to be put in place to make sure it abides by State Aid rules.
- 3.9.** We also question for example why there is a certain capacity being maintained in professional functions which remain embedded within BBC public service such as HR directly linked to BBC Studios. This could be an inherent indirect subsidy especially if by using these services BBC Studios is able to reduce its overall costs and improve its operating margins. The impact on achieving a 'level playing field' with Indies could be even more acute in the nations where margins are arguably smaller. We believe the BBC should remove this capacity and any other staff who are embedded in BBC public service with a direct line to BBC

¹² BBC Trust, Regulatory decision on BBC Studios, p47-48, December 2016

Studios. These staff should be TUPEd across to BBC Studios as required and form part of its own operating costs consistent with other commercial companies. We ask Ofcom to question the efficiency and thinking behind maintaining this potential overcapacity within BBC public service. We are particularly interested in how Ofcom will scrutinise the flexibility BBC Studios will be given to procure services from the open market versus buying services from BBC Group. Ofcom must ensure that when it comes to the latter BBC Studios proves that services were bought at fair market rates.

- 3.10.** We are pleased that Ofcom highlights the possibility and risks associated with the BBC having an unfair advantage if it were to pay less than the market price for services or goods. We agree with Ofcom's requirement on the BBC to use market benchmarking and that it is requiring the BBC to justify any pricing that may be set without reference to the market.
- 3.11.** Finally on training and standards, whilst we acknowledge the important role which the BBC continues to play in training and standards, we note that the BBC's investment in this important area has drastically reduced in recent years. According to the BBC's annual training report, the core funding for BBC Academy fell from £21.3m in 2012/13 to £17.3m in 2013/14. This was the result of the BBC's 'Delivering Quality First' scheme, launched in 2011, which imposed a 35% cut to the BBC Academy's budget by 2013.
- 3.12.** In addition, the BBC has previously failed to recognise the important (and increasing) role which the independent production sector plays in this area. In 2013, the last year for which figures are available, UK indies invested over £40m on diversity, training and skills.
- 3.13.** Clarity is needed on how the BBC would ensure that BBC Studios staff had access to training while avoiding cross-subsidy. Pact would expect, for example, that any training opportunities provided to Studios by the BBC public service would be made available on the same terms to external production companies.
- 3.14.** When BBC Studios is commercialised, then its incentives to invest in training would become commercial. Furthermore, BBC Studios employees could not benefit from training opportunity from BBC public entity if they were not also available on the same terms of external production companies.

4. Commercial rate of return

- 4.1.** Pact welcomes Ofcom's proposal that the requirement for a commercial rate of return should apply separately to each 'line of business' rather than only at the level of each commercial subsidiary. It is important that all BBC commercial activities generate a return for the licence fee payer and to enable licence fee payers to see that they are getting value for money from these services. It is also important that all revenues are transparent and that it is made clear in the BBC annual report how the money from BBC commercial subsidiaries are accounted for in terms of increased investment in content production.
- 4.2.** Pact disagrees that the BBC's commercial activities need not generate a profit every year particularly if it is a new activity. Given the size and scale of the BBC it will always have an impact on how new activities are carried out. If we take BBC Studios for example at the outset this will start with a market share of just under 21% this is not as the BBC identifies a 'start-up'.¹³ If they are not to be profitable Ofcom should insist that the unitary board seriously considers scaling back or ceasing operations before Ofcom carries out an investigation. It is unclear in the current requirements which part of the BBC will have the responsibility to consider ceasing operations if it fails to meet a commercial return. This should be clarified. BBC Studios has been deliberately set up as a mature scale business and we expect that it should seek profit maximization as soon as possible rather than accepting marginal profits for potentially strategic purposes. We would hope that the transparency that Ofcom will insist on regarding marginal profits will be investigated as part of its requirements for establishing an appropriate commercial rate of return.
- 4.3.** This is a critical issue in judging if BBC Studios is operating in the broader commercial market in a fair manner that does not distort proper competition. All commercial competitors will either close or dispose of failing subsidiaries. This can often lead to major restructuring and other consequences for commercial failure. If BBC Studios is to be a truly commercial subsidiary then it must also be subject to the same jeopardy as other commercial competitors. This in turn means that it must deliver a reasonable rate of return consistent with other commercial competitors in the market. If it does not and its level of return to the BBC is consistently below market norms then it should either be restructured or closed. If this cannot happen then it is reasonable to assume that BBC Studios is being maintained as an under-performing subsidiary purely for strategic reasons. This would be contrary to the BBC's own stated rationale for the creation of BBC Studios.

¹³ BBC Studios , 4CC Main Case, August 2016

4.4. As a consequence this would not lead to larger returns to the BBC and the BBC licence fee payer and may be acting as a barrier to growth in the UK production sector by distorting the market for BBC commissions and or international rights.

5. Monitoring, reporting and transparency

5.1. Pact welcomes Ofcom's requirements for the BBC to publish methodologies it proposes to use to establish transfer prices for each type of good or service that the public service supplies to commercial activities including the methodologies it uses for valuing BBC brands. However we reiterate that at least a range of prices should be published as part of this effort if 'actual prices' are not possible.

5.2. We agree that any changes to the methodologies of calculating prices should be notified to Ofcom. We also welcome that reports and accounts covering each of the commercial subsidiaries will be published and that this contains the forward looking commercial rate of return for each line of business including a quarterly review.

5.3. However there is a lack of clarity on what Ofcom will do if it discovers that some of the pricing is under cutting or distorting the market – a clearer mechanism should highlight what happens once this is established as well as explicit guidance for third party complaints.

Section 4: Material changes to commercial activities

6. BBC processes

6.1. Under the Charter Agreement the BBC must publish a policy on how it will judge materiality (linked to changes to commercial activities) and how it will conduct its assessments. As currently set out there is no obligation for the BBC to consult Ofcom or other stakeholders. We believe Ofcom should encourage the BBC to consult Ofcom and others before finalising its policy.

6.2. We note that Ofcom has pushed for the BBC to carry out a commercial test on any proposed material change and has highlighted that it expects the BBC to consider whether the commercial activity resulting from the material change complies with the fair trading and separation rules. We also note that this will be published and sent to Ofcom. We endorse the proposal that the BBC is being encouraged to publish as much information as possible and will be required to explain why the BBC may redact information in any published version of a proposal to Ofcom. It is unclear however in this section whether the BBC will be required to publicly publish a non confidential version of any proposal. There should be an explicit requirement for the BBC to publish their proposal to enable third parties to comment on plans.

6.3. It is unclear how third parties can raise concerns with regards to material changes where they think a material change has been implemented without going through the assessment process – we would like clarification from Ofcom that they will be open to these kinds of concerns. Whereby Ofcom could carry out investigations of their own initiative.

7. Ofcom processes

7.1. We welcome Ofcom's plans to assess whether a change is material and that Ofcom will make a judgement on whether the information supplied by the BBC is enough to make a decision on whether the change is material. We also welcome Ofcom's ability to ask the BBC for more information including the resubmitting or republishing of their plans if the information is initially lacking. However it is unclear how Ofcom will ensure the BBC allows for enough time for third parties to be consulted. We insist that this is made more explicit in any guidance especially given that Ofcom expects to only offer a 2 week window for third parties to comment on proposals given that they expect the BBC to have consulted with enough time prior to the Ofcom process.