

BBC COMMERCIAL REVIEW

December 2018

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This report, commissioned by the BBC Board, provides a review of the BBC's commercial activities. The Board is under a requirement to undertake this review by the Corporation's Framework Agreement with the Department for Digital, Culture, Media and Sport by 31 December 2018. Specifically, the review assesses whether the Corporation's commercial subsidiaries meet the four "commercial criteria" required by the Agreement. We are pleased with the finding that each of the BBC's commercial subsidiaries meets all four of the commercial criteria.

The commercial subsidiaries play a vital role in the overall BBC Group – it is through these companies that the BBC undertakes the vast majority of its content production activities; the commercial distribution of its content; the provision of international news services; and the provision of strategically important studio facilities in London. We are proud that these companies are within the BBC Group and they provide a valuable contribution to the Corporation, which support the BBC's UK Public Services.

In July, the Board commissioned EY as independent external consultants to undertake the review on its behalf and we are pleased to be able to publish their report here in full.

The review has looked in detail at all of the commercial activities the BBC operates through its three main commercial subsidiaries: BBC Studios; BBC Global News; and BBC Studioworks. EY considered the current conditions in each of the markets in which these subsidiaries operate, as well as whether they meet the four "commercial criteria" set out in Clause 23(5) of the Agreement.

These four "commercial criteria" are:

1. the activities must fit with the Mission and the Public Purposes;
2. the activities must exhibit commercial efficiency;
3. the activities must not jeopardise the good reputation of the BBC or the value of the BBC brand; and
4. the activities must not, as a result of the relationship of the activity with the UK Public Services, trading activities or non-service activities, distort the market or create an unfair competitive advantage.

The Board welcomes EY's conclusion in the report that our commercial activities meet all four of these commercial criteria.

In undertaking the review on the Board's behalf, EY came to a number of conclusions and recommendations which are summarised on page 18. The Board accepts these conclusions and will begin implementation of the recommendations.

The Board is particularly pleased that EY found that, based on their extensive benchmarking work and their understanding of the practices of other market operators, each of the BBC's commercial subsidiaries exhibits commercial efficiency in line with their peer groups and the wider market.


The report also concluded that the BBC has in place embedded processes and policies throughout the Corporation – including the UK Public Services, trading activities, non-service activities, and commercial activities – to ensure that it complies with Ofcom's trading and separation requirements and mitigating any potential risk of market distortion.

Informed by this report, the BBC Board has now set performance measures and targets for each of its commercial subsidiaries. These targets are referenced against EY's work, which has set out what would be considered a commercial rate of return in the markets in which each main subsidiary operates. These targets also reflect the ambitions that the BBC has for its commercial activities and how they work to support the BBC. As required by the Agreement, we are publishing alongside this report further details of these targets for each commercial subsidiary.

The BBC Board will keep these targets under review, and will continue to require the BBC's commercial subsidiaries to provide regular updates on their commercial performance.

We have separately also reviewed the governance and oversight of the BBC's commercial subsidiaries and have agreed changes to the membership and composition of the BBC's Commercial Holdings Board. We will strengthen this Board – which is responsible for ensuring that the commercial subsidiaries deliver against the agreed strategy – with the addition of non-executive directors from the main BBC Board, including as chair. These changes are being published separately.

The Board thanks EY for this work and I would like to thank my colleagues, Steve Morrison and Anne Bulford, who along with myself oversaw this review on behalf of the Board.

A handwritten signature in black ink, reading "David Clementi". The signature is written in a cursive style with a large, stylized 'D' and 'C'.

Sir David Clementi
BBC Chairman

17 December 2018

A review of the BBC's commercial subsidiaries

Final report

December 2018

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1. Executive summary

1.1 Introduction

The BBC is established by a Royal Charter (the “Charter”), which sets out the BBC’s independence, mission, public purposes, obligations and governance. In addition to its Charter, the BBC operates under a Framework Agreement (the “Agreement”) with the Secretary of State for Digital, Culture, Media and Sport (“DCMS”), which provides further context to the Charter and covers the BBC’s funding and regulatory duties.

The Charter and Agreement permit the BBC to undertake commercial activities alongside its public service broadcasting activities, subject to certain requirements¹. As part of these requirements, the Agreement states that the BBC’s commercial activities must comply with **four commercial criteria**:

1. *The activities must fit with the BBC’s Mission and the Public Purposes;*
2. *The activities must exhibit commercial efficiency;*
3. *The activities must not jeopardise the good reputation of the BBC or the value of the BBC brand; and*
4. *The activities must not, as a result of the relationship of the activity with the UK Public Services, trading activities or non-service activities, distort the market or create an unfair competitive advantage.*

The BBC’s main² commercial subsidiaries currently consist of BBC Studios Limited (referred to herein as “Studios”), BBC Global News Limited (referred to herein as “Global News”) and BBC Studioworks Limited (referred to herein as “Studioworks”):

1. **Studios** is responsible for production and distribution activities. Studios was created in its current form in April 2018 following the merger between: the legacy BBC Studios Limited, which was established as a commercial subsidiary in 2017 to produce TV, radio and digital content for the BBC and external clients; and BBC Worldwide (“Worldwide”), which was responsible for sales, distribution and exploitation of BBC content, format, brands, channels and intellectual property.
2. **Global News** operates the BBC’s international 24 hour TV channel, BBC World News, and the BBC.com digital platform, which publishes news, sports and features content on international websites and mobile applications. These activities are commercially funded through advertising sales, and sales to pay TV operators that offer the BBC World News channel to their subscribers.
3. **Studioworks** provides television studio facilities, equipment and crew, as well as post-production services to the BBC’s UK Public Services, BBC Studios and external clients. Its core facilities are based in London and the South East.

1.2 Scope of work

The Agreement states that the BBC must carry out and publish two or more detailed reviews on whether its commercial activities, carried out through its commercial subsidiaries, meet the commercial criteria (referred to hereafter as the “commercial review”). The first commercial review must be completed by 31 December 2018, and subsequent commercial review(s) must be completed by the end of the period covered by the Charter, which is 2027.

¹ These requirements are set out in detail in Section 2 of this report.

² In the remainder of this document, the term “commercial subsidiaries” refers collectively to the three main commercial subsidiaries of Studios, Global News and Studioworks. We note that each of Studios and Global News carries out activities through a range of further subsidiaries.

EY has been commissioned to conduct the first commercial review on behalf of the BBC Board. We have assessed relevant BBC information, interviewed a range of BBC stakeholders, and conducted our own analysis using BBC data and publicly available information. We began by reviewing the strategic context in relation to the markets in which the commercial subsidiaries operate (as summarised in Section 1.3), before reviewing each commercial criterion in turn (as summarised in Sections 1.4 to 1.7).

1.3 The BBC's commercial subsidiaries and the markets in which they operate

We have assessed the market context in which each of the commercial subsidiaries operates, focusing on the following markets:

- ▶ Production and distribution – relevant to Studios;
- ▶ News and features provision – relevant to Global News; and
- ▶ Production facilities – relevant to Studioworks.

In doing so, we have considered the implications of market change and development for each of the BBC's commercial subsidiaries.

1.3.1 Markets for production and distribution

- ▶ Households' viewing is shifting away from traditional TV to other forms of media. These other forms of media are primarily delivered online, and include broadcast catch-up content, streaming services and short-form content. The fragmentation of consumers' viewing time has increased the competition for audiences' attention for traditional broadcasters like the BBC. As viewing increasingly becomes fragmented across different platforms, Studios' ability to exploit intellectual property rights is becoming critically important.
- ▶ Much of the change in consumers' viewing behaviour is associated with the rapid emergence and growth of on-demand streaming propositions, which often have global footprints. Many of these platforms are still operating in a growth phase, and are investing heavily to secure exclusive content and to offer a compelling library of content. The content market is increasingly becoming global, and demand is increasing. While this offers opportunities for Studios to monetise growing demand for new and archive content, and to deliver returns to the BBC, it also poses challenges – for example, growing competition for talent may be increasing costs for production companies.
- ▶ The plurality of content supply in the UK is decreasing as production companies consolidate, or are acquired by channels and platforms looking to diversify revenue streams and seeking greater control over intellectual property. In this context, Studios provides the BBC's UK Public Services with certainty of supply of content, and a strong production arm in an increasingly concentrated market.

1.3.2 Market for international news

- ▶ International TV news is a mature market, with two established English-language global news providers: CNN and the BBC. News consumption patterns are changing: while television continues to be the most used platform for news overall, the internet is the most popular platform among younger age groups³. Increasing fragmentation of news provision and consumption online has increased the level of competition that Global News faces. Accordingly, its television news services are likely to face challenges in growing, or even maintaining, audience numbers.

³ Ofcom, (2018). *News consumption in the UK: 2018*. [online]. Available at: https://www.ofcom.org.uk/data/assets/pdf_file/0024/116529/news-consumption-2018.pdf

- ▶ These shifts in the way people access news are putting legacy business models of news providers under increasing pressure, with online news delivery proving hard for news providers to monetise. News providers continue to experiment in search of revenue diversification and sustainable profitability – for instance through paywalls, subscriptions, events, data and information research, partnerships and mergers and acquisitions – but the long-term viability of these business models is still uncertain. Global News is therefore operating in a challenging market where change is essential.
- ▶ Online news does not differentiate between regulated publishers and social media or user-generated content. Consumers are experiencing increasing uncertainty about the quality and validity of information delivered online, with over half of online news consumers reporting that they are concerned about what is real and “fake” on the internet⁴. In this context, the BBC’s reputation is a unique selling point for Global News: Global News’ research shows the BBC is ranked as the most trusted international news brand⁵. The challenge for Global News is to continue to be creative in leveraging its reputation, in a way that delivers a return sufficient to ensure its ongoing commercial viability.

1.3.3 Market for production facilities

- ▶ Studio facilities play an important role in the UK’s creative sector, and will continue to do so in the future. However, they are susceptible to fluctuations in demand (including seasonality) from channels and producers.
- ▶ Market supply from competing facilities may also fluctuate, creating both opportunities and threats. In this context, Studioworks provides the BBC with certainty of supply in a market of fluctuating capacity.
- ▶ The majority of companies operating in the studios facilities market are relatively small in scale. While the studio facilities we considered in our analysis are profitable, it is noteworthy that a number of players have left the London market in recent years due to the challenges of earning sufficient profit in a region where property costs are high. The TV studio sector is unlikely to promise large scale revenues, or growth.

1.4 Criterion 1: Fit with the BBC’s mission and public purposes

The BBC’s Charter establishes the core purpose of the BBC as being the fulfilment of its mission and the promotion of the five public purposes. The BBC’s mission, as defined in the Charter, is “*to act in the public interest, serving all audiences through the provision of impartial, high-quality and distinctive output and services which inform, educate and entertain*”⁶. This mission is underpinned by the BBC’s public purposes⁷, which are set out below:

1. *“To provide impartial news and information to help people understand and engage with the world around them;*
2. *To support learning for people of all ages;*
3. *To show the most creative, highest quality and distinctive output and services;*
4. *To reflect, represent and serve the diverse communities of all of the United Kingdom’s nations and regions and, in doing so, support the creative economy across the United Kingdom; and*
5. *To reflect the United Kingdom, its culture and values to the world.”*

⁴ Reuters Institute, 2018, Digital News Report 2018, pg. 10

⁵ Global News’ strategy document for 2018-21

⁶ BBC Charter, Section 5

⁷ BBC Charter, Section 6

The first commercial criterion requires the commercial subsidiaries' activities to fit with the BBC's mission and public purposes. The Agreement defines an activity undertaken by a commercial subsidiary as fitting with the BBC's mission and public purposes if⁸:

- a. *"It is appropriate to be carried on in association with the fulfilment of the Mission and the promotion of the Public Purposes; and*
- b. *It is connected, otherwise than merely in financial terms, with the ways in which the BBC fulfils its Mission and Promotes the Public purposes".*

1.4.1 Our approach

We have considered the extent to which the activities of each commercial subsidiary fit with the mission and public purposes. In this context, we have considered:

- ▶ **BBC processes:** We sought to understand the processes the BBC has in place to ensure that compliance with this criterion is embedded into decision-making – both for significant activities that require regulatory approval, and for more minor activities that do not pass the threshold for such approval processes.
- ▶ **Appropriateness:** We have assessed whether the activities conducted by the commercial subsidiaries *conflict with* the mission or public purposes. By way of example, in the most recent application of this criterion to a significant change to the BBC's commercial activities (in the 2016 decision in relation to the creation of the legacy Studios), the BBC Trust considered appropriateness as *"an editorial issue that is governed by the editorial guidelines"*⁹.
- ▶ **Connectedness:** Given that the Agreement requires commercial activities to be connected *"not merely in financial terms"* to the mission and public purposes, we considered the extent to which the activities conducted by the commercial subsidiaries *contribute to* the BBC in delivering its objectives, both financially and non-financially.

In practice, we treat the test of appropriateness as an initial hurdle to first consider whether each subsidiary's activities are acceptable in the context of the mission and public purposes. The test of connectedness then assesses whether the activities of the subsidiaries contribute to the mission and public purposes, both financially and non-financially. We note that, in order to meet the first commercial criterion, each subsidiary is not expected to contribute to each public purpose individually, but rather contribute to one or more of the BBC's public purposes. As the BBC's mission is underpinned by the public purposes, we consider that this is a sufficient condition to demonstrate fit with both the mission *and* the public purposes.

1.4.2 Processes and documentation

It is the responsibility of the BBC Board to ensure that the activities of the BBC contribute to the fulfilment of its mission and promotion of the public purposes. The BBC's Charter also notes that the Board must consider proposals for material changes to the commercial activities, and must assess the proposed changes in terms of their alignment with the public purposes.

From our assessment of BBC documentation, and through discussions with BBC personnel, we have observed that fit with the mission and public purposes is a well-established concept in the BBC, and that it is embedded in the way the organisation operates. It is evident from our discussions with personnel from the BBC's commercial subsidiaries, and from some of the documentation received, that as well as considering whether they *can* conduct the activity, the relevant teams and decision-makers consider whether they *should* conduct the activity, with the mission and public purposes as the relevant reference point.

⁸ BBC Agreement, Section 23 (8)

⁹ BBC Trust, 20 December 2016, *Regulatory decision on BBC Studios*

However, there is variation across the commercial subsidiaries in terms of the extent to which the mission and public purposes are specifically referenced in decision-making documents:

- ▶ **Studios:** We consider that sufficient documentation exists to demonstrate that fit with the mission and public purposes is considered during relevant decision-making processes.
- ▶ **Global News:** We consider that sufficient documentation exists to demonstrate that fit with mission and public purposes is considered within Global News' strategy and decision making. We note that there is clear alignment with key strategy documents and the mission and public purposes, and that specific reference to public purposes is made within some of these documents. We also note that Global News has updated its one slide summary of its strategy to more explicitly reference public purpose 1 – and will use this document in future internal communications.
- ▶ **Studioworks:** We note that the relevant strategy documents for Studioworks suggest a clear fit with the mission and public purposes, although the documents do not make explicit reference to these. We have not seen any evidence to substantiate that the first commercial criterion has been explicitly considered.

We understand that the BBC considers certain activities to be so obviously aligned to the public purposes that documentation may be considered unnecessary. For instance, the services provided by Studioworks enable the creation of high quality, distinctive output (public purpose 3). However, given the BBC's new regulatory requirements, the inclusion of references to the public purposes within such documentation, if applied in a proportionate manner, may be helpful for the purpose of transparency. Furthermore, there is an opportunity to promote greater consistency across the subsidiaries in demonstrating fit with mission and public purposes.

1.4.3 Appropriateness and connectedness of commercial activities

We have tested the BBC's commercial activities for their appropriateness and connectedness. Taking each subsidiary in turn, we have found the following:

- ▶ **Studios**
 - ▶ **Appropriateness:** Through its strategy, governance structures, geographic footprint, and financial returns, there are a number of controls in place which ensure that Studios' activities do not conflict with the fulfilment of the mission and public purposes, and therefore pass the initial hurdle of appropriateness. For example, Studios remains wholly-owned and governed by the BBC; the BBC's UK Public Services is Studios' largest customer; and Studios' geographic footprint aligns with the BBC's requirements and programming quotas.
 - ▶ **Connectedness:** We consider that Studios contributes to all of the public purposes – for instance through factual content (public purpose 1); specialist educational content (public purpose 2); a consistent supply of content to the BBC's UK Public Services (public purpose 3); production across the Nations and Regions of the UK (public purpose 4); and producing and distributing UK content around the world (public purpose 5).
- ▶ **Global News**
 - ▶ **Appropriateness:** We consider the activities of Global News to pass the initial hurdle of appropriateness. In particular, by providing independent, impartial and trusted news around the world via TV, the internet and mobile, Global News' activities do not conflict with the BBC's mission and public purposes. Its activities must comply with the BBC's Editorial Guidelines on impartiality, editorial integrity and conflicts of interest, ensuring that they do not conflict with the wider objectives of the BBC.
 - ▶ **Connectedness:** Global News' strategy and focus are centred on providing impartial news (public purpose 1) and reflecting the UK to the rest of the world (public purpose

5), and are at the core of Global News' existence. Beyond these, Global News also contributes to the most of the other public purposes – for instance through informational content on its BBC.com feature sites, covering topics such as science, culture, travel, nature and history (public purpose 2); and the provision of high-quality, distinctive news content, through both its TV and online channels (public purpose 3).

► **Studioworks**

- **Appropriateness:** We consider that, by enabling the BBC, Studios and external producers to produce high-quality programmes in London and the South-East area, the activities of Studioworks do not conflict with the BBC's mission and public purposes, and are therefore appropriate to be carried out.
- **Connectedness:** Studioworks also contributes to most of the public purposes – for instance through supporting the production of General Election programming (public purpose 1); its work with local educational institutions (public purpose 2); its important role in the value chain for the production of BBC's UK Public Services output (public purpose 3); and its contribution to the creative economy by the provision of studios and post production services to a wide range of major TV broadcasters and production companies (public purpose 4).

1.4.4 Conclusions and recommendations

Based on the findings for each commercial subsidiary, we consider that the BBC's commercial activities fit with the mission and public purposes. However, given the BBC's regulatory requirements, the organisation should ensure that appropriate documentation is in place to demonstrate compliance with the first commercial criterion.

In light of this, we recommend the following:

- While the Agreement requires that commercial activities are appropriate to and connected with the mission and public purposes, these terms are not clearly defined – and there does not appear to be a consistent definition of these terms across the BBC. We consider that creating clear definitions for these terms would ensure consistent interpretation and application across the organisation.
- There is an opportunity to promote greater consistency across the subsidiaries in how fit with mission and public purposes is documented.

1.5 Criterion 2: Exhibit commercial efficiency

The Agreement defines commercial activities as those which are “*undertaken with a view to generating a profit (regardless of whether the profit generated will or may be used to fund the fulfilment of the Mission or promotion of the Public Purposes). This means that something can be a commercial activity even if it also fulfils the Mission or promotes the Public Purposes, if it is done with a view to generating profit*”¹⁰. The second commercial criterion requires the BBC to be satisfied that the subsidiaries' commercial activities exhibit commercial efficiency¹¹.

The Agreement further states that, as part of carrying out its commercial review, “*the BBC must set and publish measures and targets for those measures for each subsidiary to assess whether the activity exhibits commercial efficiency subject to not jeopardising the ability of the subsidiaries to operate effectively in the market*”¹².

As described in Section 1.7, Ofcom's regulatory framework also requires the BBC's commercial subsidiaries to define and report: (i) forward-looking commercial rate of return targets on an annual basis; and (ii) financial performance on a quarterly basis.

¹⁰ Agreement, Section 23 (2c)

¹¹ Agreement, Section 23 (5)

¹² Agreement, Section 29 (2)

1.5.1 Our approach

We have considered a broad definition for the term “commercial efficiency”, rather than solely focusing on the subsidiaries’ financial performance. For the purpose of this review, we have considered commercial efficiency in terms of:

- ▶ **Strategic direction:** Strategic direction is important to ensure businesses have the right focus and understand their priorities and targets. The BBC should therefore be able to demonstrate that subsidiaries have in place – and can execute – a coherent and rational business strategy to drive commercial efficiency.
- ▶ **Budget planning and monitoring:** A robust approach to financial forward planning and monitoring of performance against the plan is necessary to assess whether a business is operating in a commercially rational manner. We reviewed each subsidiary’s recent financial performance, financial planning processes and the latest set of business plans.
- ▶ **Investment appraisal:** An effective framework to govern the appraisal of investments, and/or a track record of successful investment, suggests that a business is commercially efficient. We conducted interviews with BBC personnel and reviewed relevant documentation to understand the BBC’s processes for reviewing performance and appraising investments.
- ▶ **Earning a commercial rate of return:** Ofcom requires that the BBC’s commercial subsidiaries should earn a commercial rate of return, or – in the event of a lower return (or loss) materialising – put in place and implement a plan to enable a commercial return to be generated over an appropriate period of time. The BBC also assesses the rate of return earned by its subsidiaries in the internal documentation reported to the BBC Board as part of the budget planning and monitoring process of the subsidiaries. For the purpose of this review, we consider that a subsidiary is earning a commercial rate of return if its return is within, or projected towards, a market range. As such, we conducted benchmarking analysis to compare the BBC’s financial performance against relevant comparator organisations.
 - ▶ We recognise that benchmarking has its limitations. For instance, it can be difficult to find organisations which conduct comparable commercial activities, in terms of the products or services sold and the markets within which they operate. Further, comparator organisations may be at different stages of development, and like-for-like comparable information may be difficult to identify or calculate. For example, our analysis includes comparison to subsidiaries and segments, for which group costs may not be captured due to limitations of company disclosure.
 - ▶ Our approach to benchmarking has been to consider organisations which are similar to the BBC’s commercial activities. As a result, the size of the sample (the number of comparator organisations included in the analysis) is small in a number of cases.
 - ▶ There are also other factors for which benchmarking does not account (such as market context and the particular characteristics of the benchmarked operations), which we consider when assessing whether a business is earning a commercial rate of return.

1.5.2 The BBC’s approach to commercial efficiency

We note the following points in relation to the BBC’s overall approach to commercial efficiency:

- ▶ **Strategic direction:** The BBC Board sets the overall strategy for the commercial subsidiaries, which is exercised via the board of BBC Commercial Holdings Limited. The Commercial Holdings Board has clear procedures and delegations in place with each subsidiary, which determine what the executive committees in each subsidiary are authorised to do.

- ▶ **Budget planning and monitoring:** In order to measure its financial performance, the BBC uses metrics including revenue, profitability (defined as earnings before interest, tax, depreciation and amortisation, referred to as “EBITDA”) and cash flow. Each commercial subsidiary defines an annual target for each of these metrics. In order to monitor financial performance, the BBC produces quarterly financial reports for internal governance processes, and is required to submit these reports to Ofcom. The BBC also monitors the cash flows of the commercial subsidiaries to understand the impact on its borrowing requirements, as the Secretary of State has set an aggregate limit on its net borrowing for commercial purposes of £350m.
- ▶ **Investment appraisal:** For a commercial subsidiary to obtain approval for a given investment or venture, the commercial subsidiary in question must produce a proposal, setting out at least three years of forward-looking financial data. The Commercial Holdings Board delegates certain decisions to each subsidiary’s executive committee, depending on financial thresholds, the entity and the type of investment.
- ▶ **Earning a commercial rate of return:** Ofcom does not specify the rate of return measure that it expects the BBC to use, and this measure is determined by the BBC. The BBC has chosen EBITDA margin as the key metric by which it measures rate of return of the commercial subsidiaries. The BBC focuses on EBITDA margin in the range of internal documentation it reports to the BBC Board as part of the budget planning and monitoring process of the commercial subsidiaries. We consider that EBITDA margin is an appropriate metric to measure the rate of return earned by the main commercial subsidiaries.

We summarise our findings below for each main commercial subsidiary:

▶ **Studios**

- ▶ **Strategic direction:** Studios has identified strategic priorities and regularly conducts activities that appear to be strategic in nature. Studios was formed in 2017/18 – the strategy for doing so has been well-documented, and reflects the issues noted in relation to the market context for Studios.
- ▶ **Budget planning and monitoring:** Studios has a detailed budget plan with forecasts. It reports financial information to the Board and Ofcom on an ongoing basis, and produces monthly financial reports. We therefore consider that it engages in appropriate budget planning and monitoring.
- ▶ **Investment appraisal:** There are several cases of Worldwide – Studios’ primary predecessor – undertaking significant investments that have been rigorously appraised. Where investments were not as successful as projected, in-depth analysis has been conducted to feed into and improve the appraisal of future investments.
- ▶ **Earning a commercial rate of return:** All of Studios’ lines of business are profitable. Furthermore, each line of business is either forecast to earn an EBITDA margin within the applicable benchmarked range, or is on a trajectory towards that range. Notwithstanding some potential uncertainties around Studios’ forecasts, we conclude that its lines of business earn a commercial rate of return. However, we note that the Consumer Products line of business is particularly difficult to benchmark as a standalone activity.

▶ **Global News**

- ▶ **Strategic direction:** Global News has prepared an in-depth strategy document analysing a number of areas (which reflects the issues noted in relation to the market context for Global News), and with a clear aim to improve profitability.
- ▶ **Budget planning and monitoring:** Global News has a detailed budget plan with forecasts. It reports financial information to the Board and Ofcom on an ongoing

basis, and produces quarterly and monthly financial reports. It engages in sufficient budget planning and monitoring.

- ▶ **Investment appraisal:** Global News has a clear framework in place for the appraisal of investments, and there are various measures in place to ensure that this framework is adhered to.
- ▶ **Earning a commercial rate of return:** Global News' 2017/18 EBITDA margin is within the range of EBITDA margins of comparator news providers, although we have observed a wide range of returns in our benchmarking assessment. That said, the commercial outlook for Global News is finely balanced, given the challenging market in which it operates (as highlighted in 1.3.2). News providers are responding to the market by experimenting with a range of different business models, with varying degrees of success, but there is as yet no consensus on the best route to long-term profitability. Global News has developed, and is implementing, a strategy that seeks to respond to the changing market environment. Execution of this strategy will be essential for Global News to secure sustainable profitability and to continue earning a commercial rate of return in the longer term.

▶ **Studioworks**

- ▶ **Strategic direction:** Studioworks' budget pack includes its objectives and proposed actions to achieve these objectives. Our discussions with Studioworks indicate that the business takes into account the issues noted in relation to the market context for Studioworks. However, we have not seen a separate and clearly defined strategy document as part of our work, noting that any such documentation should be proportionate to the size and complexity of the business.
- ▶ **Budget planning and monitoring:** Studioworks has a budget plan with forecasts. It reports financial information to the Board and Ofcom on an ongoing basis, and produces quarterly and monthly financial reports. It engages in sufficient budget planning and monitoring.
- ▶ **Investment appraisal:** Studioworks' investment decisions predominantly focus on lower value equipment purchases linked to a clear revenue stream, rather than higher value, complex investments. Its investment decision-making process and documentation is scaled accordingly. Studioworks' closure of its lossmaking Digital Media Services segment indicates a commercial approach to larger, more complex investment appraisal.
- ▶ **Earning a commercial rate of return:** Studioworks' EBITDA margin was within the benchmarked range for 2017/18, and is also forecast to be within the range of margins for the comparator organisations identified. While there may be some revenue and cost uncertainties regarding Studioworks' forecasts, there is likely to be consistent market demand for Studioworks' services in the future. We therefore conclude that Studioworks is earning a commercial rate of return.

1.5.3 Conclusions and recommendations

Based on our analysis, we consider that each of the BBC's commercial subsidiaries is commercially efficient. Each has in place a clear strategy and budget plan. We have reviewed case studies for investment appraisal and have seen appropriate processes in place to consider the commercial efficiency of investments. Further, these case studies indicate that lessons are learned and appropriate actions taken in respect of less successful investments to better inform future decision-making. Finally, we consider that each subsidiary is currently earning a commercial rate of return, as our benchmarking analysis indicates that returns are within, or projected towards, a market range – but we note that the market context going forward looks challenging for Global News.

In light of this, we recommend:

- ▶ The BBC considers whether there is scope for more systematic and regular review at the BBC Group level of historical, actual and projected performance. This information is especially relevant in the light of Ofcom's greater scrutiny of this area. Our interviews with BBC stakeholders also indicate that there may be scope for the main BBC Board to monitor the performance of the commercial subsidiaries more closely, in a manner proportionate to their business size and complexity.
- ▶ Given the challenging market in which Global News operates, execution of its strategy – to secure sustainable profitability, and therefore ongoing commercial efficiency – should be a key area of focus for the BBC.
- ▶ The BBC should consider benchmarking a useful tool to provide an indicative range to assess the performance of its commercial subsidiaries, but should also consider other factors (such as the changing market context and the particular characteristics of the BBC's commercial activities) when assessing whether a business is earning a commercial rate of return. In this context, we note that the Consumer Products line of business for Studios is particularly difficult to benchmark as a standalone activity. The BBC should therefore consider the most appropriate method for benchmarking its activities going forward.

1.6 Criterion 3: Not jeopardise the good reputation of the BBC or the value of its brand

According to the Agreement, the third commercial criterion requires that the BBC's commercial activities "*must not jeopardise the good reputation of the BBC or the value of the BBC brand*". Given the BBC's business is primarily content creation and distribution, maintaining the BBC's editorial standards and values across its commercial services is the most important factor in ensuring that the BBC's reputation and brand are protected. However, the criterion is broader than editorial standards alone: the BBC's reputation and brand could be affected by a range of other factors, from the partners that the commercial subsidiaries choose to work with, to health and safety and information security issues.

1.6.1 Our approach

In assessing the BBC's commercial subsidiaries with the third criterion, we have considered:

- ▶ **The overall framework through which the BBC seeks to protect its reputation and brand value:** We have considered the specific guidelines and requirements that the BBC has in place relating to its reputation and brand; and
- ▶ **The specific application of that framework to each of the commercial subsidiaries:** We have considered the practical application of the BBC's overall approach by each subsidiary, as well as any specific guidelines or requirements relating to each subsidiary.

1.6.2 The BBC's approach to protecting its reputation and the value of its brand

The BBC has an extensive range of policies and guidelines in place designed to safeguard its reputation and brand value. The commercial subsidiaries must consider these policies and guidelines when seeking to ensure that their activities comply with the third commercial criterion.

At the core of these are the BBC's Editorial Guidelines, which reflect the editorial values and standards of the BBC. The Editorial Guidelines give advice to content producers on how to deal with contentious editorial decisions, and how to ensure content meets audiences' expectations.

In addition to the Editorial Guidelines, the commercial subsidiaries must comply with other BBC guidelines and requirements – including the Advertising and Sponsorship Guidelines, which set out the principles and standards for advertising and sponsorship on the BBC's commercial

services; Guidelines for BBC Commercial Services on Editorial Integrity and Independence from External Interests, which seek to ensure the BBC is independent of arrangements that could “*undermine its editorial integrity, independence or impartiality*”; and BBC Branding Guidelines, which are provided by the BBC’s Central Branding team, with more in-depth guidelines for commercial subsidiaries produced on a case-by-case basis.

Overall, these guidelines and requirements aim to ensure that content produced, broadcast and distributed by the commercial subsidiaries meets the high standards required of content produced by the BBC; and to ensure that audiences are clear about the distinction between the licence-fee funded UK Public Services and the BBC’s commercial subsidiaries with regard to advertising and sponsorship. Taken together, we consider that these guidelines, if complied with, would sufficiently safeguard the BBC’s reputation and brand.

We summarise our findings below for each subsidiary:

▶ **Studios**

- ▶ We note that Studios has an extensive range of processes in place to ensure that its activities safeguard the reputation and brand of the BBC – including the appointment of appropriate responsible personnel, clear escalation and approval routes, and explicit consideration of reputational and brand issues in the context of commercial ventures. These processes are well documented. It is evident from our review that reputational and branding considerations were properly taken into account in cases such as the sale of BBC Good Food to Immediate Media, corporate sponsorship deals and the sale to AMC Networks of a stake in BBC America.
- ▶ Studios also has in place sufficient processes and governance to ensure compliance with more general BBC policies such as health and safety, information security and antifraud and corruption. This includes producing an Ethics and Compliance report to track any potential issues, which is reviewed at the Compliance and Risk Committee on a quarterly basis, and is submitted to the Studios Executive Committee for noting.
- ▶ We recognise that the process for maintaining editorial standards for third-party productions, including for third-party branded content, is still evolving since the merger between Worldwide and legacy Studios. The BBC is progressing work in this area, which will require further monitoring and review.

▶ **Global News**

- ▶ Through our review, we consider that Global News is committed to protecting the BBC’s reputation and brand. Global News follows the Editorial Guidelines and interacts regularly with the Editorial Policy team. It has processes in place to ensure compliance with the Advertising and Sponsorship Guidelines, including an Advertising Governance Committee, a named Advertising Standards Guardian, and processes for assessing potentially contentious advertising.
- ▶ Our review suggests that Global News is selective about the partners it chooses to work with and considers the potential implications of its commercial relationships for the BBC’s reputation and brand. Global News shared with us the framework it uses to ensure compliance with respect to external relationships, which sets out the compliance and escalation process.
- ▶ We understand that, as of November 2018, Global News produces an Ethics and Compliance report for the Commercial Holdings Board on a quarterly basis. This Ethics and Compliance report is based on Studios’ report, as outlined above.

▶ **Studioworks**

- ▶ Studioworks has stated that it sees itself as presenting a lower risk to the BBC’s reputation and brand from an editorial perspective than the other commercial

subsidiaries: it considers itself a facilities provider, and therefore does not seek to exploit the BBC brand in the same way as Studios and Global News. We understand that Studioworks takes comfort from the fact that customers are Ofcom-licensed broadcasters, which lowers the risk of any negative impact on the BBC's reputation and brand. However, we consider that Studioworks still has the potential to present a risk in other ways – for instance, as a result of the clients and suppliers that it chooses to work with, as well as more general issues like health and safety considerations and its data protection policies.

- ▶ From our interviews with relevant BBC personnel and review of the documents that Studioworks provided, we conclude that Studioworks has processes in place to protect the BBC's reputation and brand. Studioworks has due diligence processes in place, which ensure that Studioworks must consult the Editorial Policy team before working with any third party with the potential to undermine the BBC's editorial integrity. Studioworks also has a comprehensive health and safety policy, and complies with the BBC's data protection regime.

1.6.3 Conclusions and recommendations

Overall, we consider that the commercial subsidiaries are committed to safeguarding the BBC's reputation and brand. We have not identified any specific occasions, practices or partnerships that risk causing damage to the BBC's reputation and brand.

However, we note that each of the subsidiaries ensures compliance with the third commercial criterion in different ways, and there may be more scope for knowledge sharing and consistency, to the extent appropriate, between the subsidiaries. For example, Global News told us that it is following Studios' approach to ensuring compliance with the BBC's general ethics and compliance framework. There may be other such areas where consistency of approach across the subsidiaries is beneficial.

In light of this, we recommend that the BBC carries out an internal study to understand how similar issues relating to reputation and brand are dealt with by different subsidiaries, to understand whether there is more scope for knowledge sharing.

1.7 Criterion 4: Not distort the market or create an unfair competitive advantage

The fourth commercial criterion requires that the BBC's commercial activities "*must not, as a result of the relationship of the activity with the UK Public Services, trading activities or non-service activities, distort the market or create an unfair competitive advantage*".

1.7.1 Our approach

To assess whether the BBC complies with the fourth commercial criterion, we have considered the internal policies the BBC has in place to ensure compliance with the regulatory framework; the processes it has implemented to put the policies into effect; and its governance of those policies and processes.

It is important to be clear that this criterion – and therefore the boundary of our review – relates to the relationship between the BBC and its commercial subsidiaries, which is overseen by the BBC in the context of the requirements of the Agreement, and the consequential regulatory framework put in place by Ofcom.

For the avoidance of doubt, we do not consider whether the BBC's commercial activities are compliant with competition law. Further, while we have reviewed the processes the BBC has put in place in relation to the regulatory framework to the extent we consider appropriate in this context, we have not carried out a full process audit.

1.7.2 Elements of the regulatory framework

The Agreement requires Ofcom to set trading and separation rules for the BBC, which ensure that the commercial subsidiaries comply with the fourth commercial criteria. The Agreement states that the trading and separation rules may include requirements to ensure appropriate separation between the BBC and its commercial subsidiaries, and to ensure appropriate transparency as to the relationship between the BBC and its commercial subsidiaries.

Ofcom places trading and separation rules on the BBC, which require that:

- ▶ Relationships between the BBC's UK Public Services, trading activities and non-service activities and the commercial subsidiaries operate at arm's length;
- ▶ Commercial activities are carried out in accordance with normal market principles, including making a commercial rate of return; and
- ▶ The relationship between the BBC's UK Public Services, trading activities and non-service activities and the commercial subsidiaries is appropriately transparent, including providing Ofcom with financial reports and the publication of information.

These requirements are set out in Ofcom's operating framework, which sets out the BBC's obligations in the following areas:

- ▶ **Operational separation:** All commercial activities must be undertaken through separate commercial subsidiaries, and arrangements must be put in place to ensure that the commercial subsidiaries do not have access to information from the BBC's UK Public Services, trading activities and non-service activities that could provide the former with an unfair competitive advantage.
- ▶ **Supply and pricing of goods and services:** Where the BBC provides goods and services to commercial subsidiaries, it must ensure that transactions are made on arm's length commercial terms. Further, the requirement for non-discrimination means that, where the BBC supplies goods and services to the wider market, it must offer these on equivalent terms to those offered to its commercial subsidiaries. The regulatory framework requires that the BBC should set market prices and terms for the good and services it supplies, using an open market process (e.g. competitive tendering) where appropriate. Where this is not possible, it should benchmark against verifiable comparable information on prevailing market practices where possible. Where there are no relevant market benchmarks or evidence on market practice, the BBC may adopt a cost-based approach.
- ▶ **Commercial rate of return:** The regulatory framework requires that the BBC's commercial subsidiaries make a commercial rate of return, in order to ensure that public funding is not used to subsidise a loss-making commercial activity, and that these activities are undertaken on an arm's length basis and in accordance with normal market principles. As part of the monitoring and enforcement of this requirement, the BBC is required to inform Ofcom annually of the forward-looking commercial rate of return for each subsidiary and line of business. In addition, the BBC must inform Ofcom of any line of business that is not making a commercial rate of return and, in that event, review performance and consider any necessary steps.
- ▶ **Material changes to commercial activities:** Under the operating framework, the BBC must publish a policy regarding material changes to commercial activities. Such material changes are subject to a formal Ofcom approval process. The Agreement defines a material change to include the creation of a new commercial activity, or a significant change to a commercial arm of the BBC, where the change creates a significant risk of market distortion or unfair competitive advantage, as a result of the relationship between the commercial subsidiaries and the UK Public Services, non-service activities or trading activities.

1.7.3 Our assessment of the BBC's approach to complying with the regulatory framework

Overall, we consider that the BBC is complying with this criterion. We summarise our findings in relation to the BBC's policies, processes and governance arrangements below.

- ▶ **BBC policies:** It is evident that the BBC has conducted detailed analysis, reviewed Ofcom's requirements and aligned its policies to ensure it is complying with the regulatory framework. In particular, the BBC has published a range of policies, which provide external parties with an overview of how the commercial subsidiaries comply with the regulatory framework. For example, the BBC has published the principles it follows to comply with Ofcom's transfer pricing requirements, as well as detailed group trading manuals for each commercial subsidiary. It has also published a detailed policy on material changes to commercial activities. The BBC has also been complying with its reporting requirements and submissions to Ofcom.
- ▶ **BBC processes:** We consider that the BBC has embedded processes throughout the commercial activities to ensure it is complying with the requirements. We note that the requirements are still relatively new, and therefore there are areas where processes can still be improved or better implemented to improve efficiency. However, our view is that the processes currently in place ensure that the BBC is complying with its requirements. These include processes relating to operational separation, regulatory complaints, and internal commercial arrangements. In relation to commercial rate of return, we consider that there is scope for further clarity to ensure that the BBC supplies forward-looking commercial rates of return to Ofcom in a manner consistent with the requirements of the regulatory framework. We understand that the BBC is clarifying information requirements with Ofcom in the context of Ofcom's recent consultation into trading and separation.
- ▶ **Governance arrangements:** We consider that, in general, the governance arrangements in this area are appropriate and sufficient. For example, the BBC has in place a clear governance structure running from the BBC Board down to the individual commercial subsidiaries, and the Fair Trading Committee provides a clear decision-making body for issues relating to compliance with trading and separation requirements. We understand that the BBC's approach to governance reflects its understanding of the Charter obligations in relation to the role of the BBC Board and directors – notably that the Board's responsibilities cover both public service and commercial activities.

1.7.4 Conclusions and recommendations

We conclude that the commercial subsidiaries do not – as a result of their relationship with the UK Public Services, non-service activities or trading activities – distort the market or gain an unfair competitive advantage. We consider that the BBC has embedded processes and policies throughout the BBC Group – including the UK Public Services, trading activities, non-service activities, and commercial activities – to ensure that it is complying with Ofcom's requirements.

However, in relation to the supply and pricing of goods and services, the BBC should consider undertaking spot checks of transactions to review transfer prices. This would provide an additional test to ensure transfer prices are appropriate and proportionate.

1.8 Overall conclusions and recommendations

Overall, we conclude that the commercial activities carried out through **the BBC's commercial subsidiaries meet the four commercial criteria**. That said, there is scope for improvement in the BBC's application in certain areas. We recommend that the BBC monitors performance, and takes action where appropriate, in order to ensure ongoing compliance with the criteria. Below we summarise our conclusions and recommendations for the BBC.

The four commercial criteria:			
1. Fit with the BBC's mission and public purposes	2. Exhibit commercial efficiency	3. Not jeopardise the good reputation of the BBC or the value of its brand	4. Not distort the market or create an unfair competitive advantage
General			
<ul style="list-style-type: none"> ▶ The need to consider fit with the mission and public purposes is embedded into the BBC's culture and practices ▶ Creating clear definitions for the terms 'appropriateness' and 'connectedness' would help to ensure the terms are interpreted consistently across the organisation ▶ There is an opportunity to promote greater consistency across subsidiaries in the documentation of fit with the mission and public purposes 	<ul style="list-style-type: none"> ▶ The commercial subsidiaries currently exhibit commercial efficiency ▶ There may be scope for more systematic and regular review at the BBC Group level of historical, actual and projected financial performance ▶ We consider that EBITDA margin is an appropriate metric to measure rate of return 	<ul style="list-style-type: none"> ▶ The commercial subsidiaries do not jeopardise the BBC's reputation or the value of its brand ▶ There may be scope for more knowledge sharing between the commercial subsidiaries ▶ The BBC should carry out an internal piece of work to understand where consistency of approach to compliance with the third commercial criterion across the subsidiaries is beneficial 	<p>We have assessed this criterion collectively across the three subsidiaries:</p> <ul style="list-style-type: none"> ▶ The BBC has appropriate policies, processes and governance to enable compliance with this criterion ▶ The BBC's transfer pricing arrangements meet Ofcom's requirements. The BBC may consider undertaking spot checks of transactions to ensure transfer prices remain appropriate
BBC Studios			
<ul style="list-style-type: none"> ▶ Studios has a clear fit with the mission and public purposes ▶ Fit is clearly reflected in decision-making and documentation 	<ul style="list-style-type: none"> ▶ Studios' activities exhibit commercial efficiency 	<ul style="list-style-type: none"> ▶ Studios does not jeopardise the BBC's brand or reputation ▶ The processes for the distribution activities are well-established and documented ▶ We note that Studios is currently reviewing the processes for the production activities due to production for non-BBC third parties 	
BBC Global News Limited			
<ul style="list-style-type: none"> ▶ Global News has a clear fit with the mission and public purposes ▶ Fit is reflected in decision-making and documentation 	<ul style="list-style-type: none"> ▶ Global News' activities currently exhibit commercial efficiency, based on the strategy it is implementing ▶ However, the commercial outlook for Global News is finely balanced, given the market context it is operating within 	<ul style="list-style-type: none"> ▶ Global News does not jeopardise the BBC's brand or reputation 	
BBC Studioworks			
<ul style="list-style-type: none"> ▶ Studioworks has a clear fit with the mission and public purposes ▶ Fit is not specifically referenced in documentation 	<ul style="list-style-type: none"> ▶ Studioworks' activities exhibit commercial efficiency 	<ul style="list-style-type: none"> ▶ Studioworks does not jeopardise the BBC's brand or reputation 	

2. Introduction and background

2.1 Overview

The BBC is the UK's largest public service broadcaster, funded by the TV licence fee, which is paid by UK households (and other premises) that watch or record live television. The BBC uses TV licence fee income to provide public service broadcasting activities, which comprise television, radio and online services. The BBC collected £3.8bn of TV licence fees for 2017/18¹³.

In addition to these public service broadcasting activities, the BBC engages in commercial activities with a view to generating a profit to supplement its TV licence fee income. These commercial activities are carried out through separate subsidiaries, which make use of the BBC's content and infrastructure. The BBC's commercial activities generated £1.4bn of revenue for 2017/18¹⁴.

2.2 The BBC's operating model

The BBC is established by a Royal Charter (the "Charter"), which sets out the BBC's independence, mission, public purposes, obligations and governance. The current Charter is effective from 1 January 2017 until 31 December 2027.

In line with the Charter, the BBC conducts the following public service broadcasting activities, which are carried out by the UK Public Services and the World Service:

- ▶ National television channels: BBC One, BBC Two, BBC Four, CBBC, CBeebies, BBC News, BBC Parliament and BBC Alba;
- ▶ An online television channel: BBC Three;
- ▶ National radio stations: Radio 1, 1Xtra, Radio 2, Radio 3, Radio 4, Radio 4 Extra, Radio 5 Live, 5 Live Sports Extra, 6 Music and BBC Asian Network;
- ▶ Local radio stations for England;
- ▶ National television and radio services for Northern Ireland, Scotland and Wales;
- ▶ Various websites providing BBC news and sport information, BBC iPlayer, children's websites, BBC Sounds and learning services through BBC Online;
- ▶ Interactive television services through the BBC Red Button; and
- ▶ International television and radio news, speech and discussions in over 30 languages through the BBC World Service.

The BBC also conducts commercial, trading and non-service activities. The Charter permits the BBC to undertake commercial activities alongside the BBC's UK Public Services, trading activities, non-service activities and World Service, provided that the commercial activities¹⁵:

- ▶ *"Fit with the Mission and Public Purposes;*
- ▶ *Are not funded by licence fee revenue;*

¹³ BBC, 11 July 2018, *Annual report 2017/18*, [online]. Available at:

<https://www.bbc.co.uk/corporate2/insidethebbc/howwework/reports/ara>

¹⁴ BBC, 11 July 2018, *BBC Commercial Holdings Limited Annual report 2017/18*

¹⁵ BBC Charter, [online]. Available at::

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/577829/57964_C_M_9365_Charter_Accessible.pdf

- ▶ *Are undertaken with a view to generating a profit;*
- ▶ *Are undertaken through separate subsidiaries (which the BBC may maintain, establish or acquire);*
- ▶ *Comply with the BBC’s general duties around acting in the public interest, engagement with the public and openness and transparency; and*
- ▶ *Do not, as a result of their relationship with the UK Public Services, non-service activities or trading activities, distort the market or gain an unfair competitive advantage.”*

These commercial activities are carried out through separate subsidiaries¹⁶, with the main subsidiaries currently consisting of BBC Studios (referred to herein as “Studios”), BBC Global News Limited (referred to herein as “Global News”) and BBC Studioworks (referred to herein as “Studioworks”)¹⁷:

1. **Studios** is responsible for production and distribution activities. Studios was created in its current form in April 2018 following the merger between the legacy Studios, which was established as a commercial subsidiary in 2017 to produce TV, radio and digital content for the BBC and external clients; and Worldwide, which was responsible for sales, distribution and exploitation of BBC content, format, brands, channels and intellectual property.
2. **Global News** operates the BBC’s international 24-hour TV channel, BBC World News, and the BBC.com digital platform, which includes the international BBC.com website, and news and sports applications. These activities are commercially funded through advertising sales, and the TV channel receives additional revenue through payments made by other distributors that offer the BBC World News channel to their subscribers.
3. **Studioworks** provides television studio facilities, equipment and crew, as well as post-production services to the BBC’s UK Public Services, Studios and external clients. Its core facilities are based in London and the South East.

2.3 Governance of commercial activities

2.3.1 The commercial criteria

In addition to its Charter, the BBC operates under a Framework Agreement (the “Agreement”) with the Secretary of State for Digital, Culture, Media and Sport (“DCMS”). The Agreement sets out the following four **commercial criteria** to which the BBC’s commercial activities must adhere:

1. *The activities must fit with the BBC’s Mission and the Public Purposes;*
2. *The activities must exhibit commercial efficiency;*
3. *The activities must not jeopardise the good reputation of the BBC or the value of the BBC brand; and*
4. *The activities must not, as a result of the relationship of the activity with the UK Public Services, trading activities or non-service activities, distort the market or create an unfair competitive advantage.*

¹⁶ The BBC cannot directly carry out commercial activities. It is, however, allowed to engage in certain trading activities, which are defined as activities whose primary aim is not to make a profit. A full list of trading activities is included in Section 31(2) of the Agreement.

¹⁷ In the remainder of this document, the term “commercial subsidiaries” refers collectively to the three main commercial subsidiaries of Studios, Global News and Studioworks. Each of Studios and Global News carries out activities through a range of further subsidiaries.

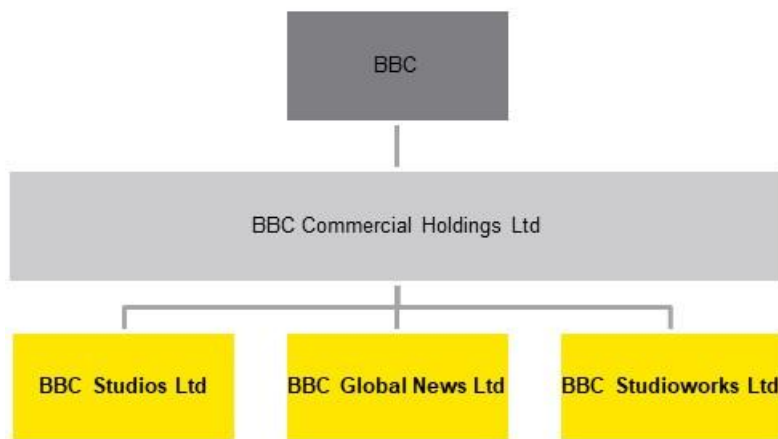
The Agreement states that the BBC must carry out and publish two or more detailed reviews during the Charter period on whether the commercial activities carried out through the BBC's main subsidiaries meet the commercial criteria (referred to hereafter as the "commercial review"). The first commercial review must be completed by 31 December 2018.

The BBC's previous regulatory regime required the commercial activities to be considered against the four commercial criteria. Specifically, the BBC Trust required the BBC Executive to produce a report that represented "a formal opinion on compliance with the commercial services criteria"¹⁸. As such, each subsidiary produced an annual report referred to as the '4 Commercial Criteria Compliance Report' ("4CC report"). We have reviewed these documents as part of this review.

2.3.2 Commercial ownership structure

As depicted in Figure 1, the BBC's three main subsidiaries are owned by BBC Commercial Holdings Limited ("Commercial Holdings").

Figure 1: BBC commercial ownership structure (only main commercial subsidiaries are shown)



2.3.3 Role of the Board

The Charter sets out that the BBC Board is responsible for ensuring that the BBC fulfils its mission and promotes the public purposes, and for securing the effective and efficient management of the BBC and its commercial subsidiaries. The Charter further requires the BBC Board to set "a strategy and governance arrangements for the BBC's commercial activities and for assessing the effectiveness of those activities"¹⁹.

The BBC Board's responsibilities include setting the overall strategy for the commercial activities, ensuring that the BBC assesses the effectiveness of the commercial activities, and considering proposed material changes to the commercial activities. The main subsidiaries are all ultimately accountable to the BBC Board, but each also has its own Executive Committee which manages the strategy and day-to-day operations, as shown in Figure 2.

¹⁸ BBC Trust. April 2015 [online]. Available at: http://downloads.bbc.co.uk/bbctrust/assets/files/pdf/regulatory_framework/protocols/2015/c4_commercial_services.pdf

¹⁹ BBC Charter, Section 20 (3)(j)

Figure 2: BBC governance²⁰



The Commercial Holdings Board monitors the performance and operations of the main commercial subsidiaries. The main subsidiaries' Boards undertake directors' statutory responsibilities (e.g. production of annual accounts and dividend payment approval). The Commercial Holdings Board includes one non-executive director; that director is not a member of the main BBC Board. Likewise, the non-executive members of the BBC Board are not on the Boards of the commercial subsidiaries.

²⁰ A range of further committees also sit under each of the subsidiaries' executive committees. For instance, Studios' Executive Committee is reported to by its Compliance & Risk Committee, Pay Committee, Investment Committee, IP Investment Committee, Production Leadership Group and various regional committees.

3. Scope and approach

3.1 EY's scope of work

The Agreement states that the BBC must carry out and publish two or more detailed reviews before the end of 2027 on whether the commercial activities carried out through the BBC's main subsidiaries meet the commercial criteria. EY has been commissioned to conduct the first of these reviews on behalf of the BBC Board, to enable it to meet the requirement to complete the first commercial review by 31 December 2018.

The review considers the three main subsidiaries through which the BBC carries out commercial activities – namely Studios, Global News and Studioworks. In conducting the review, we consider whether the commercial activities carried out by the BBC meet the four commercial criteria. We note in this context that the Agreement states that the BBC's commercial activities *must* meet the commercial criteria – as such, the review is binary in nature: activities either do or do not meet each commercial criterion. While we deal with each criterion in turn, in practice the criteria are interconnected. There are potential trade-offs and linkages between them, but no one criterion is superior to any other.

We consider the commercial activities as they are currently organised, and have reviewed financial information for this year (2018/19) and three years of BBC forecasts²¹. We also consider historical information (i.e. prior to the current Charter period), such as relevant case studies, in order to inform our assessment.

3.2 Overall approach

In order to conduct the review, we have assessed relevant BBC information, interviewed a range of BBC internal stakeholders, and conducted our own analysis using BBC data and publicly available information. Specifically, we have reviewed the BBC's commercial activities by adopting the following methodology:

- ▶ **Review of documentation and financial information:** For the purpose of this review, we identified a wide range of documentation to be provided by the BBC. This documentation included: historic and prospective financial information for each subsidiary; relevant BBC policies and procedures; relevant Board (and other internal) papers relating to the strategy and operations of the commercial subsidiaries; BBC submissions to public bodies; and third party reports and analysis commissioned by the BBC. Our review has drawn on this information and on other publicly available information – for instance published financial reports, and reports by public bodies including the National Audit Office (“NAO”) and the Public Accounts Committee.
- ▶ **Interviews with BBC stakeholders:** We held interviews with a wide range of BBC stakeholders across group functions and within the commercial subsidiaries. The purposes of these interviews were to understand the practical steps the BBC takes in seeking to meet the commercial criteria, and to identify and gather the necessary evidence to enable us to carry out our review of the subsidiaries' compliance with the criteria. Our interviews included (but were not limited to) the following:
 - ▶ Corporate Finance representatives including the Group Finance and Operations Director and the Head of Corporate Finance;
 - ▶ Members of the Regulation and Economics, Legal, Strategy, and Editorial Policy teams;

²¹ The BBC typically produces forecasts with three years of forward-looking financial data. We have therefore aligned our review period with the BBC's internal practices.

- ▶ Senior board-level individuals including the Chairman, the Deputy Director-General, Group Commercial Director, and two Non-Executive Directors;
 - ▶ Studios: CEO, CFO, General Counsel and Director of Regulatory Affairs;
 - ▶ Global News: CEO, COO and the Strategy Manager; and
 - ▶ Studioworks: MD and Head of Finance & Business Operations.
- ▶ **EY analysis and assessment:** We have drawn on our market understanding and specific analysis to enable us to identify the material issues for this review. This included: a review of the strategic context of the markets in which the BBC’s commercial subsidiaries operate, and the changing competitive dynamics in those markets; an assessment of the BBC’s application of the relevant policies and procedures it has in place in order to enable compliance with the commercial criteria; and financial analysis and benchmarking of the performance of the subsidiaries against market comparators. For the avoidance of doubt, EY has not been asked to comment on the effectiveness of the corporate and business strategies for each commercial subsidiary, nor have we been engaged to advise on or develop the future strategies for the subsidiaries.

3.2.1 The BBC’s commercial subsidiaries and the markets in which they operate

We assessed the strategic context in relation to the markets in which the commercial subsidiaries operate, including how the competitor set is changing over time and the implications of that market context for the BBC’s commercial subsidiaries. Our approach focused on the following markets:

- ▶ Production and distribution – relevant to Studios;
- ▶ International news – relevant to Global News; and
- ▶ Production facilities – relevant to Studioworks.

3.2.2 Fit with the mission and public purposes

We assessed each commercial subsidiary in turn and considered the extent to which its activities fit with the mission and public purposes. We considered:

- ▶ **Appropriateness:** Based on the BBC’s requirements as described in the Agreement, we have assessed whether the activities conducted by the commercial subsidiaries *conflict with* the mission or public purposes. By way of example, in the most recent application of this criterion to a significant change to the BBC’s commercial activities (in the 2016 decision in relation to the creation of Studios), the BBC Trust considered appropriateness as “*an editorial issue that is governed by the editorial guidelines*”²².
- ▶ **Connectedness:** Given that the Agreement requires commercial activities to be connected “*not merely in financial terms*” to the mission and public purposes, we considered the extent to which the activities conducted by the commercial subsidiaries *contribute to* the BBC in delivering its objectives, both financially and non-financially.

We sought to understand the processes the BBC has in place to ensure that compliance with this criterion is embedded into decision-making – both for significant activities that require regulatory approval, and for more minor activities that do not pass the threshold for such approval processes. We considered specific case studies and reviewed the associated documentation to assess how the first criterion was considered throughout the process. We note that in order to meet the first commercial criterion, each subsidiary is not expected to

²² BBC Trust, 20 December 2016, *Regulatory decision on BBC Studios*

contribute to each public purpose individually, but rather contribute to one or more of the BBC's public purposes. As the BBC's mission is underpinned by the public purposes²³, we consider that this is a sufficient condition to demonstrate fit with both the mission *and* the public purposes.

3.2.3 Exhibit commercial efficiency

While the Agreement does not explicitly define commercial efficiency, we consider a broad definition for this term. Specifically, in order to demonstrate commercial efficiency, we consider that each subsidiary must demonstrate:

- ▶ **Strategic direction:** Strategic direction is important to ensure businesses have the right focus and understand their priorities and targets. Commercial businesses must therefore have in place – and execute – an appropriate strategy. The BBC should therefore be able to demonstrate that subsidiaries have a coherent and rational business strategy to drive commercial efficiency.
- ▶ **Budget planning and monitoring:** Financial forward planning and monitoring of performance against the plan is necessary to assess whether a business is operating in a commercially rational manner. We reviewed each subsidiary's financial planning processes and the latest set of business plans. We summarised and reviewed recent financial performance, focusing on the three measures of performance that the BBC's main commercial subsidiaries report to Ofcom annually – revenue, profitability, and free cash flow (post-interest and tax) ("FCF").
- ▶ **Investment appraisal:** An effective framework to govern the appraisal of investments, and/or a track record of successful investment, suggests that a business is commercially efficient. We conducted interviews with BBC personnel and reviewed relevant documentation in order to understand the BBC's processes for reviewing performance and appraising investments.
- ▶ **Earning a commercial rate of return:** Ofcom requires that the BBC's commercial subsidiaries should earn a commercial rate of return, or – in the event of a lower return (or loss) materialising – put in place and implement a plan to enable a commercial return to be generated over an appropriate period of time. For the purpose of this review, we consider that a subsidiary is earning a commercial rate of return if its return is within, or projected towards, a market range. As such, we conducted benchmarking analysis to compare the BBC's financial performance against relevant comparator organisations. We also considered other factors, such as market context and the particular characteristics of the BBC's commercial activities, when assessing whether a subsidiary is earning a commercial rate of return.

3.2.4 Not jeopardise the good reputation of the BBC or the value of its brand

In assessing the BBC's commercial subsidiaries' compliance with the third criterion, we considered:

- ▶ **The overall framework through which the BBC seeks to protect its reputation and brand value:** We considered the specific guidelines and requirements that the BBC has in place relating to its reputation and brand.
- ▶ **The specific application of that framework to each of the commercial subsidiaries:** We considered the practical application of the BBC's overall approach by each subsidiary, as well as any specific guidelines or requirements relating to each subsidiary.

Our review has been based on discussions with the Editorial Policy team, the Marketing and Audiences team and the commercial subsidiaries. We also reviewed documentation provided by these teams and other relevant personnel within the BBC.

²³ BBC Charter, Section 6

3.2.5 Not distort the market or create an unfair competitive advantage

We focused on the requirements of Ofcom's regulatory framework, and the BBC's approach to complying with the regulatory obligations relevant to the relationship between the BBC and its commercial subsidiaries. For the avoidance of doubt, we do not consider whether the BBC's commercial activities are compliant with competition law. Further, while we have reviewed the processes the BBC has put in place in relation to the regulatory framework to the extent we consider appropriate in this context, we have not carried out a full process audit.

We reviewed a range of BBC and third-party documents to enable us to understand and summarise the BBC's regulatory framework, the processes it follows to comply with this framework, and the external scrutiny of its compliance.

3.3 Structure of this report

The remainder of this report is structured as follows:

- ▶ **Section 4: The BBC's commercial subsidiaries and the markets in which they operate** – This section describes the activities of the BBC's main commercial subsidiaries, and analyses the markets in which they operate. This section includes a discussion of key competitors, relevant market trends and implications of market change for each of the subsidiaries.
- ▶ **Sections 5-8: Commercial criteria** – These sections consider the three main commercial subsidiaries and describe our approach and findings in relation to each of the commercial criteria:
 - ▶ Section 5: Fit with the BBC's mission and public purposes;
 - ▶ Section 6: Exhibit commercial efficiency;
 - ▶ Section 7: Not jeopardise the good reputation of the BBC or the value of its brand; and
 - ▶ Section 8: Not distort the market or create an unfair competitive advantage.
- ▶ **Section 9: Overall conclusions and recommendations** – This section summarises our findings relating to each of the commercial criteria for each commercial subsidiary, and sets out our recommendations.

4. The BBC's commercial subsidiaries and the markets in which they operate

4.1 Overview

The BBC's three main subsidiaries contributed £1.4bn of revenue in 2017/18, with Studios accounting for approximately 91%, Global News around 7% and Studioworks the remaining 2%. In this section, we set out the activities of each of the commercial subsidiaries in more detail. This section also sets out our assessment of the market context in which each of the commercial subsidiaries operates, focusing on the following markets:

- ▶ Production and distribution – relevant to Studios;
- ▶ News provision – relevant to Global News; and
- ▶ Production facilities – relevant to Studioworks.

We consider the drivers of change in each of the above markets and the resulting evolution of the competitive landscape and associated business models. In doing so, we have considered the implications of market change for each of the BBC's commercial subsidiaries.

4.2 Studios

Studios is the BBC's commercial production and distribution subsidiary. The current subsidiary was created in April 2018, following the merger between the legacy Studios (the spin-off production arm from the BBC established in April 2017) and Worldwide, which was responsible for the production, sales, distribution and exploitation of BBC brands, channels and intellectual property.

The new Studios is a global content company, which seeks to fulfil the BBC's mission and promote the public purposes through its investment in quality content and the financial returns that are reinvested into the BBC for the benefit of the UK TV licence fee payer.

As a commercial subsidiary, Studios owns the rights to new content produced across a range of genres. Studios creates and invests in content across the UK's Nations and Regions, and distributes it at a global level. Studios consists of the following five lines of business²⁴:

- ▶ UK Production;
- ▶ International Production & Formats;
- ▶ Content Sales²⁵;
- ▶ Branded Services²⁶; and
- ▶ Consumer Products.

Given the above lines of business, we have considered the production and distribution markets as the most relevant to Studios' activities, and have assessed the potential implications for Studios of change in these markets.

²⁴ BBC Studios, [online]. Available at: <https://www.bbcstudios.com/about/about-us/>

²⁵ This is also referred to as 'Distribution' within the BBC.

²⁶ This is also referred to as 'Channel Operations' within the BBC.

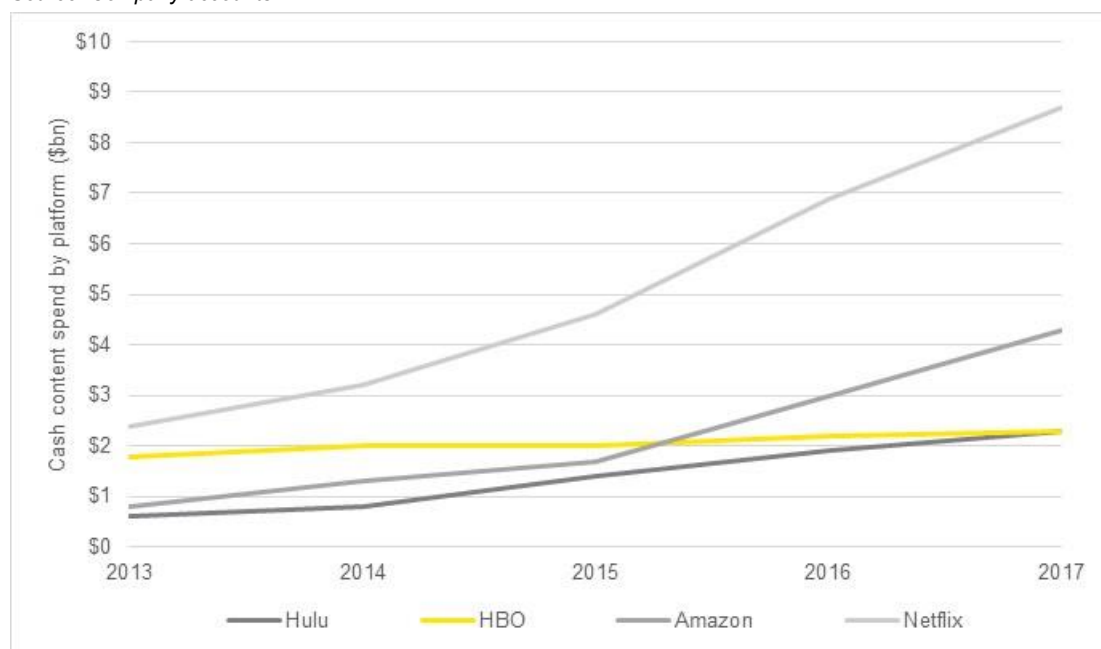
4.2.1 Markets for production and distribution

The way that people consume content is continuing to change, with households' viewing shifting away from traditional TV to other forms of media. Traditional TV viewing in the UK has declined over recent years to around three and a half hours per adult per day and 56% of UK households claimed to spend more time on the internet than watching TV in 2017 – the first time the balance shifted in favour of internet consumption²⁷. While some of this viewing has shifted to catch-up TV and TV streaming services, new forms of content have also become popular, particularly short-form content, with 71% of those aged 18-24 using mobile devices for short-form viewing of sports highlights, music and trailers within the home²⁸. Consumption on different devices and different formats adds to overall demand in a way that appears likely to increase, but traditional TV broadcasters face more competition for audiences' attention than ever before. As viewing becomes more fragmented across different platforms, ownership of intellectual property becomes increasingly valuable.

Some of the change in viewing behaviour is associated with the rapid emergence and growth of on-demand streaming propositions, like Netflix and Amazon, which often have global footprints. These platforms, many of which are still operating in a growth phase, are investing heavily to secure content intended to attract subscribers and deliver long-term monetisation. Their content budgets are increasingly directed towards content that is exclusive to the platform and is designed to drive user growth and retention. For example, in 2012, Netflix launched its first original content but five years later, in 2017, launched the equivalent of 1,257 hours²⁹. As Figure 3 shows, content spend by non-traditional players has increased significantly, especially by the pure-play online players, and significantly surpassed the BBC's television spend in 2017 (£1.6 billion)³⁰. Approximately 8% of revenue for UK production companies is now derived from on-demand services³¹. While this increase in content spend increases opportunities for production companies, it may also cause some inflation in costs, driven in part by competition for top talent.

Figure 3: Cash content spend by platform (\$bn)

Source: Company accounts



UK production and distribution companies have experienced sustained growth in the absolute value of commissions, driven primarily by overseas demand. As shown in Table 1, between

²⁷ EY, June 2018, *Are Consumers Content With Your Content*

²⁸ EY, June 2018, *Are Consumers Content With Your Content*

²⁹ IHS Markit as quoted by Digital Europe, July 2018. Available from: <https://www.digitaleurope.com/2018/07/19/ihs-markit-netflix-and-amazon-grow-local-originals-output/>

³⁰ BBC, 11 July 2018, *Annual report 2017/18*

³¹ Pact, Sept 2018, *UK Television Production Census 2018*, pg. 22

2010 and 2017, producer revenue from TV-related activities increased by 17% from £2.2 billion to £2.6 billion.

Table 1: Producer TV-related revenues: UK and international (£m)

Source: PACT, Sept 2018, UK Television Production Census 2018, Oliver & Ohlbaum analysis. Figures are in 2017 terms. Census years reflect the year the data were collected.

	2010	2011	2012	2013	2014	2015	2016	2017
Primary UK commissions	1,569	1,381	1,656	1,751	1,640	1,603	1,544	1,552
UK rights income	161	191	198	175	215	267	238	228
Other UK income	62	47	46	56	67	39	45	48
Primary international commissions	251	403	349	316	299	444	481	549
International Sales of finished Programmes	148	151	187	160	172	218	219	218
Other international income	50	47	38	36	29	45	44	36
Total revenue	2,241	2,220	2,474	2,494	2,422	2,616	2,571	2,631

Definitions: 'UK rights income' = UK secondary sales, merchandising, formats, home entertainment etc.; 'Other UK income' = pre-production and other TV-related revenue; 'Other int'l income' = international rights (excluding finished programme sales), pre-production and other TV-related revenue.

While demand for content is increasing on a global scale, the plurality of content supply in the UK is decreasing, with concentration leading to a smaller number of large producers. Between 2011 and 2014, the number of independent producers in the UK halved to around 250 and has remained relatively stable since. Formerly independent producers are now part of much larger media groups such as: All3Media, which is jointly owned by Discovery and Liberty Global; Fremantle, which is a subsidiary of RTL Group; Endemol Shine, which is half-owned by 21st Century Fox; or Shed Media, which was acquired by Warner Brothers. Channels and platforms are also acquiring producers in large part to diversify revenue streams, but also to seek greater control over intellectual property, reducing access to intellectual property rights for third parties. In contrast, there is a "long tail" of small independent producers, which tend to focus on specific genres or formats and generate annual revenues of less than £25m³².

Many of the same market dynamics that impact the production sector are equally relevant for content distribution. As new platforms, particularly on-demand services, are investing in original content, they are also looking to offer a compelling library of content. With competition focusing on end-to-end ownership of intellectual property, which allows rights holders to monetise across platforms, devices and geographies, there remain opportunities for distributors and rights owners to monetise their own catalogues and archives.

The role of distributors is significantly changing as traditional players consolidate and new entrants disrupt existing business models. For example, Endeavor, a talent agency, leverages its involvement in productions to acquire distribution rights and act as a sales agent. Vertical integration has seen distribution become part of larger, more diversified media groups. In particular, in mature media markets like the UK, the pure-play distribution model has become less prevalent. Smaller distributors tend to focus on specific content niches or are looking to grow catalogues, often through vertical or horizontal mergers and acquisitions ("M&A").

On-demand platforms, particularly those without traditional channel or network businesses, are disintermediating established distribution models. These platforms (such as Netflix) are securing content by approaching producers directly and securing rights across all platforms and markets. This development could create longer-term challenges to the supply of rights for secondary distribution. For instance, as more commissioning takes place on an "all rights" basis, distribution businesses may have less content available to sell on to other platforms, markets, or through other release windows.

³² PACT, UK Television Production Census

The on-demand platforms also have a mix of business models, which translates to different competitive imperatives and different budgets. For example, some are funded by advertising, subscription or a combination of both, while others use their streaming services as loss-leaders to grow other parts of the business. These market participants tend to have strong balance sheets, which enable them to fund content investment. In contrast, the ability of many incumbent platforms and broadcasters to pay for rights is under pressure, forcing them to squeeze margins further down the value chain. For example, pay TV revenue is being squeezed by new entrants offering cheaper alternatives. While this varies significantly in different markets, the pressure to compete is increasing. In parallel, consumer spending is becoming more fragmented and although consumers are increasingly willing to pay for content, with overall spend on the rise, it is spread across a wider range of service providers. In the advertising market, structural changes mean platforms and broadcasters are currently struggling to generate the same levels of return from the shift to digital as from legacy services. Together, the combination of consumer spending and advertising pressure is challenging the ability to acquire rights.

Leading companies in the UK producer and distributor landscape are detailed in Table 2. These companies represent a mix of direct competitors to Studios, a range of businesses aligned to broadcasters, and subsidiaries of larger international media groups.

Table 2: Leading Producers/Distributors

Source: Company accounts (2017 unless otherwise stated); EY analysis

2017	Revenue (£m)
ITV Studios business	1,582
Fremantle Media	1,308
BBC Studios ³³	1,300
ALL3MEDIA Holdings Limited	598
Entertainment One (Television segment only, excluding the Mark Gordon company)	365

4.2.2 Implications of market change for Studios

The market changes outlined above raise a number of considerations for Studios:

- ▶ The fragmentation of viewing across different platforms and devices has increased competition for the BBC's linear TV channels. When consumers are increasingly agnostic about the platform on which they access content, Studios' ability to exploit intellectual property rights is becoming critically important.
- ▶ As the market for content becomes more global, Studios faces more competition (for commissions and for talent), but also has increased opportunities to monetise growing demand for content, and deliver returns to the BBC.
- ▶ In the context of both this global market and a declining number of independent producers, Studios provides the BBC with certainty of supply of content, and a strong production arm in a concentrated market.

4.3 Global News

Global News operates the BBC's two commercially-funded international news services: BBC World News, the 24-hour global news television channel, and the digital platform BBC.com (including the BBC.com website, a News application, and a Sport application). BBC World News television is available in more than 200 countries and territories worldwide, including over

³³ Pro forma figures for the combined entity are a proxy measure provided by the BBC, calculated using audited figures only from Worldwide's and legacy Studios' financial statements. The pro forma measure itself has not been audited and no audited pro forma data currently exists on the merged Studios entity.

458 million households and 3 million hotel rooms³⁴. BBC.com offers international news, analysis and feature sites which include BBC Capital, BBC Culture, BBC Future and BBC Travel, for computers, tablets and mobile devices to more than 95 million unique browsers each month³⁵.

The mission of Global News is *“to be the best and most trusted international news provider in the world, while growing the BBC’s international news audiences and operating as a commercially efficient business”*³⁶. The TV channel and BBC.com are commercially funded through advertising sales, and the TV channel receives additional revenue through payments made by other distributors that offer the BBC World News channel to their subscribers.

4.3.1 Market for international news

News consumption habits are also fragmenting. In the UK, while television continues to be the most used platform for news overall, the internet is the most popular platform among 16-24s and ethnic minority groups³⁷. International TV news is a mature market, with two established English-language global news providers: CNN and the BBC. However, there is a large and diverse number of news providers online, with news consumption shifting towards mobile and social and a myriad of formats such as messenger apps, podcasts, newsletter and emails. The market for news is now intensely competitive, posing new challenges for more established news providers in television and print media.

Changing news consumption patterns, particularly among younger age groups, mean that television news providers are likely to face challenges in growing, or even maintaining, audiences. Similar challenges have already been seen in the newspaper market, where the circulation of national newspaper titles has decreased by nearly 60% between 2003 and 2017³⁸. While many print and television news providers have increased their online news offering, online news delivery is proving hard for news providers to monetise, with only 14% of online news consumers paying for access³⁹. As a result, the business models of news providers are under increasing pressure.

Many news providers depend on advertising, but the advertising market continues to be challenging. Online advertising poses particular issues for news providers, in part due to the market strength of leading aggregators. For instance, Google and Facebook account for almost 60% of all global advertising on mobile, and in some markets this rises to over 80%⁴⁰. While these large technology platforms, and others like Snap Inc. and Twitter, provide a new platform for news distribution and monetisation, they also compete directly with online news providers for advertising revenues.

News providers are continuing to experiment with business models in search of revenue diversification and sustainable profitability. Examples of such efforts include paywalls, subscriptions, events, data and information research, partnerships and M&A. Each approach has pros and cons: for instance, while paywalls have negative implications for reach, they balance this by enabling the capture of first-party data. The Guardian Media Group has adopted an approach of accepting voluntary reader contributions, which number in excess of half a million regular payments⁴¹. Companies such as the Daily Mail and General Trust have a long established track record of business-to-business data analytics and events services, and have enjoyed success with strategic growth investments. The New York Times has recently launched a Products & Ventures team to develop new revenue streams. In contrast, some news providers are run as loss-leaders in support of other parts of the business, such as Sky News, while others are state-funded or subsidised, such as France 24 and RT (formerly Russia

³⁴ BBC Annual report and BBC World News website, [online]. Available at: <https://www.bbc.co.uk/mediacentre/worldnews/2018/bbc-news-in-india-fake-news>

³⁵ *ibid*

³⁶ Global News’ strategy document for 2018-2021

³⁷ Ofcom, (2018). *News consumption in the UK: 2018*. [online]. Available at: https://www.ofcom.org.uk/data/assets/pdf_file/0024/116529/news-consumption-2018.pdf

³⁸ Ofcom, (2018). *News consumption in the UK: 2018*. [online]. Available at: https://www.ofcom.org.uk/data/assets/pdf_file/0024/116529/news-consumption-2018.pdf

³⁹ Reuters Institute, 2018, *Digital News Report 2018*, pg. 22

⁴⁰ eMarketer, March 2018, *Facebook vs Apple Share of Digital Ad Spending, 2016-2020*

⁴¹ Guardian Media Group, 1 April 2018, *Annual Report 2018*, pg. 2

Today). Many global players are consolidated into larger media corporations, as in the model of CNN with WarnerMedia or Yahoo in Oath, while others are supported by private equity and corporate investors to realise growth, including BuzzFeed and Vice.

The success and long-term sustainability of these business models is still unclear, with no consensus on the best route to long-term profitability. As evidenced in Table 3, there is now significant diversity among news providers in terms of scale. We consider the profitability of news providers in Section 6.

Table 3: Leading News Providers

Source: Company accounts (2017, unless otherwise stated)

	Revenue (£m)
News Corp*	3,754
The New York Times Company	1,241
Daily Mail and General Trust plc**	683
Guardian Media Group plc	217
ITN Limited	126
Global News	106
Buzzfeed UK Limited***	21

* News & Information Services only

** DMGT Media only

*** 2016

Online news does not differentiate between regulated publishers and social media or user generated content. As use of online news providers grows, consumers are experiencing increasing uncertainty about the quality and validity of information, with over half of online news consumers (54%) reporting that they are concerned about what is real and “fake” on the internet⁴². In this environment, high-quality, trusted news sources are of continued importance to consumers. A reaction against so-called “fake news”, combined with a continued appetite for quality news, could place trusted sources in a strong position to attract audiences.

4.3.2 Implications of market change for Global News

The market changes outlined above are relevant to Global News:

- ▶ The economics of providing news is very challenging – traditional TV and print providers may face difficulties in growing, or even maintaining, audiences. Similarly to Studios, Global News faces increasing levels of competition and a market shift from linear TV to on-demand consumption. Global News is therefore operating in a challenging market where change is essential.
- ▶ Given concerns about “fake news”, traditional trusted news brands may be in a strong position to attract consumers who are increasingly uncertain about which sources of news are trustworthy, particularly online. In that sense, the BBC’s reputation is a unique selling point for Global News: Global News’ research shows the BBC is ranked as the most trusted international news brand⁴³. The challenge for Global News is to continue to be creative in leveraging its reputation, in a way that delivers a return sufficient to ensure its ongoing commercial viability.

⁴² Reuters Institute, 2018, Digital News Report 2018, pg. 3

⁴³ Global News’ strategy document for 2018-2021

4.4 Studioworks

Studioworks provides television studio and post production facilities to the BBC, Studios as well as other broadcasters and external production companies. Studioworks is a full services provider located across three core sites in and around London⁴⁴, as described below:

- ▶ **Elstree:** Operations are spread across two sites in Borehamwood, Hertfordshire, with the core offering comprising three fully equipped high definition (“HD”) TV studios. The studios are capable of filming in HD and of holding audiences of up to 800 people. The sites are also supported by ancillary rooms which include dressing rooms, green rooms, group rooms, production office facilities, make up and wardrobe rooms. At times of high demand, Studioworks “scales up” by taking on additional space on the Elstree Film Studios site. Studioworks also operates post-production facilities in Elstree, comprising video and audio editing technology. On the BBC Elstree site, Studioworks provides a mix of studios and post production services to Studios in relation to the continuing dramas EastEnders and Holby City.
- ▶ **Television Centre:** This facility is based in White City, London and includes three TV studios (ranging from 3,430 sq. ft. to 10,800 sq. ft.), as well as scalable post production facilities. The facility is served by an array of flexible technical and support areas including tapeless recording facilities, 4K studio cameras, resilient live broadcast lines, apparatus rooms, dressing rooms, green rooms and production offices.

4.4.1 Market for production facilities

In the UK, the market for production facilities is broadly split between those offering film facilities and those for television programmes, with the latter split between high-end TV (such as facilities used for drama production) and more traditional entertainment. Each of these three segments has a different profile in terms of growth, profit margin and risk. Film and high-end TV studios tend to provide long-term arrangements spanning many months, and are typically backed by large production budgets, while entertainment requirements are more *ad hoc*, with shows being filmed over shorter timeframes or episodically and with smaller budgets. Studioworks is focused on the non-drama TV studio market only, which is characterised as flat growth and lower margin due to the higher investment requirements and seasonality.

For TV production, demand in the UK is driven by the main traditional broadcasters, either directly or indirectly through production companies commissioned to produce output for those channels. It is the channels that are ultimately the end buyers and therefore responsible for fluctuations in demand and spend.

In recent years, the capacity in the London and South East TV studios market has decreased, as properties have been repurposed into higher-yielding (e.g. residential and commercial) uses. Examples include the downsizing of the Television Centre site from eight to three studios, the closure of Fountain Studios as well as ITV’s The London Studios. This movement has partially been offset with the growth in Pinewood Studios, other non-traditional spaces being used for TV recordings and the impending reintroduction of Riverside Studios to the market. In aggregate, while there has been a net capacity decrease in central London TV studio facilities, we understand that production demands are still being met.

The UK production sector is concentrated on London and the South East, with over two thirds of production companies located in the region⁴⁵. The focus on London and the South East reflects the clustering of specialist production facilities and talent (including both on-screen talent and freelance staff), and the potentially high cost of moving freelance staff across the UK.

The majority of companies operating in the studios facilities market are relatively small in scale, as shown in Table 4. As demonstrated in Section 6, these companies are also profitable.

⁴⁴ Studioworks provides fully-equipped facilities in Elstree and Television Centre, including scalable post production facilities.

⁴⁵ Ofcom, December 2015, Review of The Operation of The Television Production Sector, pg. 24

However, as noted above, some studios have closed in recent years due to high costs (e.g. high property costs in the South East of England) or an inability to deliver a sustainable profit.

Table 4: Leading Facilities Providers⁴⁶

Source: Company accounts (2017 unless otherwise stated)

	Revenue (£mil)
Pinewood Group Limited	80
Studioworks	31
Dock10 Limited*	25

*2016

We understand that pricing for studio space for entertainment commissions remains relatively flat. There are pressures on production budgets and, where overall spending on content production has been buoyant, this has tended to focus on film and high-end drama productions and has not filtered into other genres of TV production. Increased attention on production costs has limited inflation in spending. This is an industry with variable cost structures that utilises freelance workers and rents equipment according to need. There is also a cycle of capital expenditure associated with ensuring facilities have the latest capabilities – for example, managing the technology cycle to smooth capital expenditure in relation to new modes of internet-protocol content capture and high end production (e.g. HD and 4K UHD).

4.4.2 Implications of market change for Studioworks

As a result of the market changes described above, Studioworks needs to consider the following:

- ▶ Studio facilities play an important role in the UK’s creative sector, and will continue to do so in the future. However, they are susceptible to fluctuations in demand (including seasonality) from channels and producers.
- ▶ Market supply from competing facilities may also fluctuate, creating both opportunities and threats. In this context, Studioworks provides the BBC with certainty of supply in a market of fluctuating capacity.
- ▶ Recent studio closures in the London studio market mean that a number of new productions have moved to Studioworks, after being displaced from their historical studio locations. Given the clustering of the production sector in London, such market movements have increased the importance of Studioworks’ capacity to the BBC and other broadcasters, particularly for shows requiring specialist TV studio facilities.
- ▶ The TV studio sector is unlikely to promise large scale revenues, or growth.

⁴⁶ The figures within this table have not been aligned for differences in accounting policies. As such, comparisons are indicative rather than like-for-like.

5. Fit with the BBC's mission and public purposes

5.1 Background

5.1.1 The BBC's mission and public purposes

The BBC's Charter establishes the core purpose of the BBC as being the fulfilment of its mission and the promotion of the public purposes.

The Charter defines that the BBC's mission is "to act in the public interest, serving all audiences through the provision of impartial, high-quality and distinctive output and services which inform, educate and entertain"⁴⁷. This mission is underpinned by the BBC's five public purposes, which are set out below⁴⁸:

1. **"To provide impartial news and information to help people understand and engage with the world around them**

The BBC should provide duly accurate and impartial news, current affairs and factual programming to build people's understanding of all parts of the United Kingdom and of the wider world. Its content should be provided to the highest editorial standards. It should offer a range and depth of analysis and content not widely available from other United Kingdom news providers, using the highest calibre presenters and journalists, and championing freedom of expression, so that all audiences can engage fully with major local, regional, national, United Kingdom and global issues and participate in the democratic process, at all levels, as active and informed citizens.

2. **To support learning for people of all ages**

The BBC should help everyone learn about different subjects in ways they will find accessible, engaging, inspiring and challenging. The BBC should provide specialist educational content to help support learning for children and teenagers across the United Kingdom. It should encourage people to explore new subjects and participate in new activities through partnerships with educational, sporting and cultural institutions.

3. **To show the most creative, highest quality and distinctive output and services**

The BBC should provide high-quality output in many different genres and across a range of services and platforms which sets the standard in the United Kingdom and internationally. Its services should be distinctive from those provided elsewhere and should take creative risks, even if not all succeed, in order to develop fresh approaches and innovative content.

4. **To reflect, represent and serve the diverse communities of all of the United Kingdom's nations and regions and, in doing so, support the creative economy across the United Kingdom**

The BBC should reflect the diversity of the United Kingdom both in its output and services. In doing so, the BBC should accurately and authentically represent and portray the lives of the people of the United Kingdom today, and raise awareness of the different cultures and alternative viewpoints that make up its society. It should ensure that it provides output and services that meet the needs of the United Kingdom's nations, regions and communities. The BBC should bring people together for shared experiences and help contribute to the social cohesion and wellbeing of the United Kingdom. In commissioning and delivering output the BBC should invest in the creative economies of each of the nations and contribute to their development.

⁴⁷ BBC Charter, Section 5

⁴⁸ BBC Charter, Section 6

5. **To reflect the United Kingdom, its culture and values to the world**

The BBC should provide high-quality news coverage to international audiences, firmly based on British values of accuracy, impartiality, and fairness. Its international services should put the United Kingdom in a world context, aiding understanding of the United Kingdom as a whole, including its nations and regions where appropriate. It should ensure that it produces output and services which will be enjoyed by people in the United Kingdom and globally.”

5.1.2 **The BBC’s regulatory requirements**

The first commercial criterion requires the commercial subsidiaries’ activities to fit with the BBC’s mission and public purposes. The Agreement provides further detail in relation to this criterion, defining an activity undertaken by a commercial subsidiary as fitting with the BBC’s mission and public purposes if⁴⁹:

- a. *“It is appropriate to be carried on in association with the fulfilment of the Mission and the promotion of the Public Purposes; and*
- b. *It is connected, otherwise than merely in financial terms, with the ways in which the BBC fulfils its Mission and Promotes the Public purposes.”*

The Agreement also states that⁵⁰:

“A commercial activity does not cease to be considered to fit with the mission and the public purposes just because the activity includes activities which in themselves do not meet the requirements of paragraph (8) [i.e. the “appropriate” and “connected” requirements cited above], provided such activities support or enable other activities that do meet those requirements.”

5.2 **Our approach**

For the purpose of this review, we have assessed the following elements of the BBC’s commercial activities and their fit with the mission and public purposes:

- ▶ **The BBC’s approach to fulfilling its mission and promoting the public purposes:** We have considered the processes that the BBC has in place to ensure that compliance with this criterion is embedded into decision-making – both for significant activities that require regulatory approval, and for more minor activities that do not pass the threshold for such approval processes. We also considered specific case studies and reviewed the associated documentation to assess how the first criterion was considered throughout the process. A number of these case studies provide information prior to the current Charter period, but nonetheless help to illustrate how fit with mission and public purposes has been considered in the BBC’s commercial activities in the past.
- ▶ **Appropriateness and connectedness of commercial activities:** We have assessed each commercial subsidiary separately and considered the extent to which its activities fit with the mission and public purposes. These activities were tested for their appropriateness and connectedness based on our interpretation of the BBC’s requirements as described in the Agreement, in the following way:
 - ▶ **Appropriateness:** Based on the BBC’s requirements as described in the Agreement, we have assessed whether the activities conducted by the commercial subsidiaries *conflict with* the mission or public purposes. By way of example, in the most recent application of this criterion to a significant change to the BBC’s commercial activities

⁴⁹ BBC Agreement, Section 23 (8)

⁵⁰ BBC Agreement, Section 23 (9)

(in the 2016 decision in relation to the creation of Studios), the BBC Trust considered appropriateness as “*an editorial issue that is governed by the editorial guidelines*”⁵¹.

- ▶ **Connectedness:** Given that the Agreement requires commercial activities to be connected “*not merely in financial terms*” to the mission and public purposes, we considered the extent to which the activities conducted by the commercial subsidiaries *contribute to* the BBC in delivering its objectives, both financially and non-financially.

In practice, we therefore treat the test of appropriateness as an initial hurdle to consider if the activities of each subsidiary are acceptable in the context of the mission and public purposes. The test of connectedness then assesses whether the activities of the subsidiaries contribute to the mission and public purposes, both financially and non-financially. We note that, in order to meet the first commercial criterion, each subsidiary is not expected to contribute to each public purpose individually, but rather contribute to one or more of the BBC’s public purposes. As the BBC’s mission is underpinned by the public purposes⁵², we consider that this is a sufficient condition to demonstrate fit with both the mission *and* the public purposes.

The findings of our assessment are discussed in detail in Sections 5.3 below. To reach a conclusion about the fit of the BBC’s commercial activities with its mission and public purposes, we use internal and publicly available information, interviews held with BBC teams, and specific BBC case studies.

5.3 The BBC’s approach to fulfilling its mission and promoting the public purposes

The BBC exists to serve the public interest and, as stated in its Charter, its objective is the fulfilment of its mission and the promotion of the public purposes. Together, the mission and public purposes define the organisation’s core strategic objectives, and provide the framework through which the BBC is held to account.

It is the responsibility of the Board to ensure that the activities of the BBC contribute to the fulfilment of its mission and promotion of the public purposes. For commercial activities, a clear strategic alignment is required with the BBC’s broader objectives, and such activities must pass the tests of appropriateness and connectedness as outlined in the Agreement. The BBC’s Charter also notes that the Board must consider proposals for material changes to the commercial activities, and must assess the proposed changes in terms of their alignment with the public purposes.

From our assessment of BBC documentation, and through discussions with BBC personnel, we have observed that fit with the mission and public purposes is a well-established concept in the BBC, and that it is embedded in the way the organisation operates. It is evident that as well as considering whether they *can* conduct the activity, the relevant teams and decision-makers consider whether they *should* conduct the activity, with the mission and public purposes as the relevant reference point.

We understand that the BBC considers that commercial activities can contribute to the mission and public purposes in the three following ways:

1. **Direct:** The activity directly contributes to the mission and public purposes and there is an obvious link to the BBC’s existing activities – for example, Studios acquiring an independent production company increases its ability to sustain scale of content production for the BBC (and other broadcasters).
2. **Indirect:** There is no direct link, but the activity supports another activity which directly contributes to the mission or public purposes. For example, Studios partnering with Merlin

⁵¹ BBC Trust, 20 December 2016, *Regulatory decision on BBC Studios*

⁵² BBC Charter, Section 6

Entertainments to open CBeebies Land at Alton Towers theme park could contribute to the public purposes by enhancing the popularity of BBC-branded content and channels.

3. **Financial:** The activity generates profit that will be reinvested into the BBC's UK Public Services.

We also understand from discussions with the BBC that ideas which are clearly in conflict with either the mission or the public purposes would be rejected during initial discussions, and would not progress to be considered through formal approval processes. As a result, the documentation available for the purpose of this review has consistently outlined activities that fit with the BBC's mission and public purposes. However, we note that there is variation across the commercial subsidiaries in terms of the extent to which the mission and public purposes are specifically referenced in decision-making documents. With this in mind, the processes and documentation observed in each of the commercial subsidiaries are discussed in greater detail below.

5.3.1 Studios

Prior to the merger with legacy Studios, Worldwide prepared a 4CC report⁵³. This noted that Worldwide's Regulatory Affairs team "*regularly updates the BBC's Fair Trading department on Worldwide's specific business plans. If any aspect of Worldwide's business activity could be seen to have policy or strategy implications for the BBC, then BBC Fair Trading will seek advice from the relevant BBC experts to ensure any associated risks are identified and suitable mitigations in place.*" The BBC has confirmed that since the creation of Studios, and the subsequent merger with Worldwide, these processes are still in place in order to meet the new regulatory requirements.

We have identified a number of examples which indicate that appropriate processes have been followed, and that sufficient documentation exists to demonstrate that fit with the mission and public purposes was considered during the decision-making process:

- ▶ **Creation of Studios:** The creation of Studios was a new commercial activity and therefore required demonstration of fit with the mission and public purposes. The 4CC Main Case for Studios⁵⁴, submitted to the BBC Trust in August 2016, set out how the new entity would fit with the first commercial criterion by demonstrating Studios' role in the BBC's wider supply strategy, and its appropriateness and connectedness in relation to the mission and public purposes. For example, the document highlights how Studios' geographic footprint and a closer relationship between network and non-network production would better enable the BBC to reflect, represent and serve the diverse communities of all the UK's Nations and Regions (public purpose 4). The BBC Trust also considered how the creation of Studios would fit with the public purposes in the regulatory decision, and concluded that it was "*satisfied that the proposed role for BBC Studios is appropriate and connected, more than in merely financial terms, with the way in which the BBC promotes its public purposes*"⁵⁵.
- ▶ **AMC Networks sale:** Worldwide sold a stake in BBC America to AMC Networks in 2014. The final deal documentation for the BBC America partnership contained a 4CC report by the BBC Fair Trading team. This report included an executive overview of the key risks in the transaction and the approach taken in managing those risks. The document also clearly outlines how the commercial service would meet the tests of appropriateness and connectedness⁵⁶.
- ▶ **Extension of CBeebies Land deal, and construction of CBeebies Land Hotel:** The documentation supporting the extension of the CBeebies Land deal, and construction of

⁵³ BBC Worldwide, April 2017, *4 Commercial Criteria Compliance Report – 2016/17*

⁵⁴ BBC Submission to the BBC Trust 4CC process for BBC Studios, pages 18-37

⁵⁵ BBC Trust, 20 December 2016, *Regulatory decision on BBC Studios*, pg. 19

⁵⁶ BBC Americas Partnership Summary of Key 4CC Risks, pages 1-9

CBeebies Land Hotel⁵⁷, included a 4CC report which outlined the proposal's fit with the BBC's mission and public purposes. This report included a detailed analysis of the specific public purposes which the commercial activity would connect with (public purposes 2 and 5).

- ▶ **Acquisition of an independent producer:** As part of our review, we also received documentation and evidence of approvals for the acquisition of an independent producer in 2016. This highlighted that the BBC's Fair Trading team outlined the fit with mission and public purposes, and subsequently sought and received approval from the Assistant General Counsel.

We have not identified any documents which suggest that appropriate processes have not been followed.

5.3.2 Global News

As noted in the 4CC report from 2016/17⁵⁸, Global News follows processes and procedures in relation to the four commercial criteria, specifically with regards to seeking Fair Trading review and Assistant General Counsel approval for changes to its commercial activities.

Due to the nature of Global News' business operations, there are fewer instances when fit with mission and public purposes require specific consideration in Global News documentation. For example, we understand that Global News relies on the fact that its core News product is defined and commissioned by the BBC, and as such the news content will be subject to the BBC News Group's well-established and documented processes. In addition, compared to Studios, there are fewer acquisitions and partnerships developed, and therefore less documentation is required for decision-makers.

For the purpose of this assessment, we have identified and reviewed a number of Global News' strategic and operational documents, and have made the following observations:

- ▶ **Internal strategy presentation:** For the purpose of this review, Global News provided us with a strategy presentation from November 2017. This document clearly outlines, and specifically references, that Global News seeks to contribute towards the BBC's mission and public purposes. Specifically, it states that Global News exists to play a central role in fulfilling public purpose 5, namely *"to reflect the United Kingdom, its culture and values to the world"*. The document also shows that the subsidiary seeks to contribute to public purpose 1 *"through building the global reach and reputation of BBC World News and BBC.com"*.
- ▶ **Strategy document for 2018-2021:** Global News' strategy document for 2018-2021 states that the organisation's purpose *"is to deliver distinctive, trusted BBC content uniquely valued by audiences and commercial clients around the world"*. This document exhibits clear alignment with the public purposes, specifically in relation to public purposes 1 and 5. Specifically, the strategy document outlines Global News' objectives to provide the best and most trusted international journalism, and to grow its international audiences.
- ▶ **Quarterly performance review (July 2018):** Similarly, Global News' quarterly performance review contains progress updates against its strategy, as well as strategic priorities, risks, new initiatives and updates on organisational development. This document also appears to align with the mission and public purposes, outlining strategic priorities which seek to grow the business globally and offer news content which meets audience needs.

⁵⁷ CBeebies Land opened at Alton Towers in May 2014, under a licensing arrangement with Merlin Entertainments. In 2016, Merlin proposed to further expand the footprint of the Land to accommodate a new ride. In addition, they sought to invest in a CBeebies Land Hotel. This change to the commercial partnership was subject to Board approval and a 4CC review.

⁵⁸ Appendix C contains the specific compliance review of BBC Global News Ltd against the 4 Commercial Criteria.

We note that there is clear alignment with key strategy documents and the mission and public purpose. Given the BBC's new regulatory requirements, the continued inclusion of references to the public purposes within such documentation, if applied in a proportionate manner, may be helpful for the purpose of transparency. For example, we note that Global News has updated its one slide summary of its strategy to more explicitly reference public purpose 1 – and will use this document in future internal communications.

5.3.3 Studioworks

The 4CC report for 2016/17 notes that the services provided by Studioworks have been considered to fit with the BBC's mission and public purposes⁵⁹.

As discussed in the previous section with regards to Global News, the nature of Studioworks' operations means that there are fewer instances when fit with mission and public purposes have been explicitly considered in Studioworks' documentation (for example, there are no examples of acquisitions and partnerships, as is the case with Studios). Despite this, we have identified and reviewed a number of Studioworks' strategic and operational documents, and have made the following observations:

- ▶ **April 2018 Board Meeting:** The documentation supporting Studioworks' April 2018 Board Meeting includes the organisation's objectives, targets and activities for the upcoming financial year. There is clear alignment with the BBC's mission and public purposes, particularly in relation to improving customer experiences in order to drive high-quality output, but no explicit reference is made to the mission and public purposes within the document.
- ▶ **Company objectives:** Studioworks provided us with a strategy document which outlines its alignment with the BBC Group's wider objectives. This document outlines three objectives of the BBC, namely to "*demonstrate value for money*", "*make distinctive world class content*" and "*develop a more personal BBC*", and specifies how Studioworks' activities and objectives align with these. While these objectives broadly align with the BBC's mission and public purposes, particularly public purpose 3, no explicit reference is made to the mission and purposes within the document.

Therefore, while there is clear alignment between key strategy documents and the mission and public purposes, there is no evidence available to substantiate that the first commercial criterion has been explicitly considered. We understand that certain activities are so obviously aligned to the public purposes that documentation may be considered unnecessary. For instance, the activities conducted by Studioworks support the production of creative, high quality and distinctive output (public purpose 3). However, the inclusion of references to the public purposes within such documentation, if applied in a proportionate manner, may be helpful for the purpose of transparency. Furthermore, as there are examples of such documentation for Studios and Global News, there is an opportunity to improve the demonstration of fit with mission and public purposes across the subsidiaries by promoting greater consistency in how these are documented.

5.4 Appropriateness and connectedness of commercial activities

In this section we assess the activities of each of the commercial subsidiaries in terms of their appropriateness and connectedness, consistent with the framework outlined in the Charter and Agreement.

We define a commercial subsidiary's activities as consisting of acquisitions and investments, significant organic strategic initiatives, and the functions or lines of business. These activities are tested for their appropriateness and connectedness based on our interpretation of the BBC's requirements as described in the Agreement, as set out in Section 5.2.

In this section, we test whether the activities undertaken by each of the subsidiaries are appropriate by testing if they conflict with the mission and public purposes. To test the

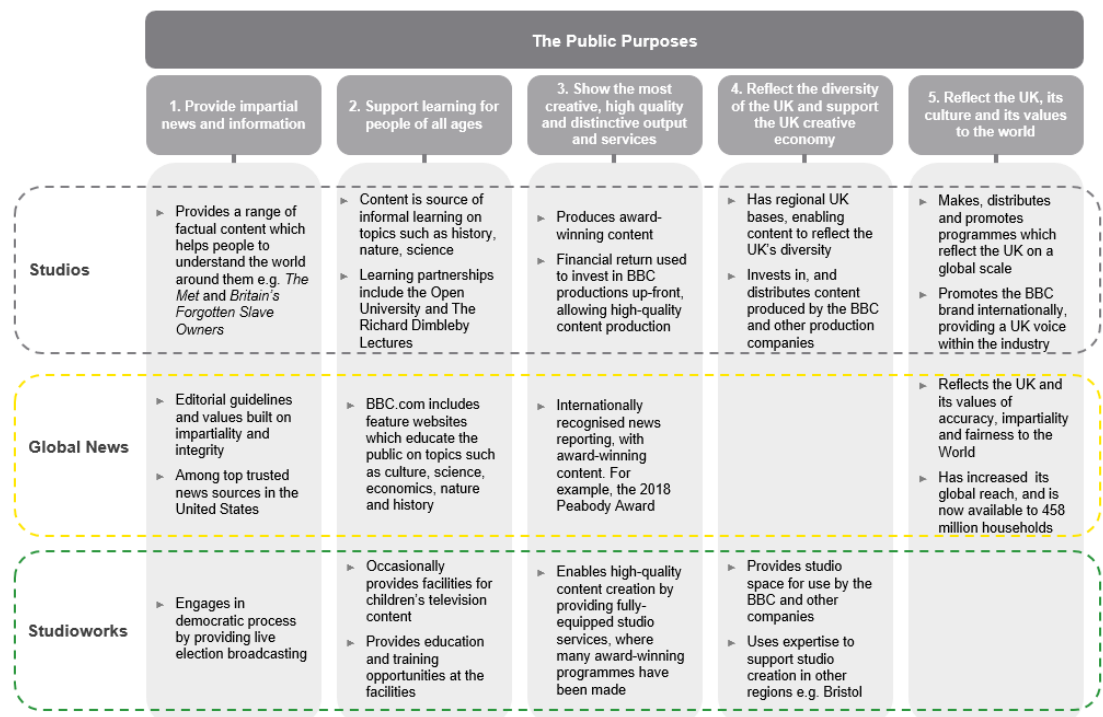
⁵⁹ Appendix D contains the specific compliance review of Studioworks against the 4 Commercial Criteria.

connectedness of the activities, we outline the contribution of the subsidiaries separately for each public purpose. We note that, in order for the BBC’s commercial activities to fit with the public purposes, each subsidiary does not have to contribute to each public purpose individually, but rather contribute to one or more of the BBC’s public purposes. We therefore do not comment on connectedness for public purposes if we do not consider them to be relevant for the commercial subsidiary.

Figure 4 provides an overview of the commercial subsidiaries’ fit across each of the five public purposes. A more detailed analysis of each commercial subsidiary is provided in the following sections.

Figure 4: Overview of fit with the public purposes

Source: EY analysis



5.4.1 Studios

5.4.1.1 Test of appropriateness

As discussed in Section 5.2, to determine appropriateness we consider whether the activities conducted by Studios conflict with the mission and public purposes.

We note that through its strategy, governance structures, geographic footprint, and financial returns, there are a number of controls in place which ensure that Studios’ activities do not conflict with the fulfilment of the mission and the promotion of the public purposes, and therefore pass the initial hurdle of appropriateness. For example:

- ▶ Studios remains wholly-owned and governed by the BBC. Studios abides by all pan-BBC standards and policies, and has access to relevant advisory units in the BBC, including the Fair Trading and Editorial Policy teams. As such, the BBC approves Studios’ editorial scope, which is reviewed at regular intervals. All of Studios’ content also abides by the BBC’s editorial standards and relevant guidance, ensuring that Studios’ content is designed to meet the needs of the BBC’s audience.
- ▶ The BBC is Studios’ largest customer, and will continue to form an important part of Studios’ strategy going forward. Studios’ mission statement is “to support the BBC Group

by producing bold, British, creative content for customers and audiences around the world". Studios accounted for 30% of the BBC's network television hours in 2017/18⁶⁰.

- ▶ Studios' geographic footprint aligns with the BBC's requirements and programming quotas, enabling the organisation to operate across the UK's Nations and Regions and reflect the diversity of the UK.

5.4.1.2 Test of connectedness

We test the connectedness of Studios' activities below, by assessing how the subsidiary contributes to each of the BBC's public purposes, both financially and non-financially.

Public purpose 1: Provide impartial news and information to help people understand and engage with the world around them

While Studios does not produce news content, we have seen that it directly contributes to this public purpose by producing a range of factual content, which is designed to help people understand and engage with the world around them.

For instance, Studios provides audiences with insights into cultural, academic, business, and political organisations across the UK. Programmes such as *Rip Off Britain* and *Watchdog* have provided information to help individuals understand their rights and responsibilities as consumers. Series such as *The Met: Policing London*, and *Britain's Forgotten Slave Owners* offer insights into the current and past organisations and structures which have governed the UK. The Science Unit and Natural History Unit, through titles including *Springwatch* and *Horizon*, also contribute to the understanding of environmental issues in the UK.

More recently, the BBC's *Blue Planet II* series (supported by investment from Worldwide) provided information that highlighted the issue of plastic pollution. After the first episode, the Marine Conservation Society saw a 169% jump in traffic to its website, the number of people searching for the WWF charity increased by 51%, and visits to the Plastic Oceans Foundation increased by 35%⁶¹.

Public purpose 2: To support learning for people of all ages

We have seen that Studios directly and indirectly acts as a source of informal education for the UK population. For instance, through its production activities, Studios directly provides a range of educational content about history, nature and science. It creates history programming like *Reformation: Europe's Holy War*, and *Britain's Ancient Capital: Secrets of Orkney*, as well as programming that charts the experiences and true stories of groups within UK society (such as *Queers*, *Murdered for Being Different* and the award-winning drama series *Three Girls*).

Through its distribution and sales activities, Studios licenses children's education content across the world. For example, *Something Special* is an educational show which uses songs, rhymes and Makaton sign language to promote language skills. Similarly, *Hey Duggee* is an educational programme for children with an international footprint of more than 150 territories⁶².

Studios also participates in educational activities through a range of partnerships with educational, sporting and cultural institutions, providing learning opportunities for UK and global audiences. For example, the BBC's long-term partnership with the Open University has enabled the delivery of programming including *Stargazing Live*, *The Secret History of Our Streets* and *Blue Planet II*. Studios also delivers *The Richard Dimbleby Lectures*, which in the past have featured public figures such as Bill Gates, Sir Terry Pratchett, Prince Charles and Gregory Doran.

⁶⁰ BBC, 11 July 2018, *Annual report 2017/18*

⁶¹ Resource, 5 January 2018, *The Attenborough effect: searches for plastic recycling rocket after Blue Planet, II*, [online]. Available at: <https://resource.co/article/attenborough-effect-searches-plastic-recycling-rocket-after-blue-planet-ii-12334>

⁶² BBC, [online]. Available at: <https://www.bbc.co.uk/mediacentre/bbcstudios/2018/global-licensing-show-brands>

Public purpose 3: Show the most creative, high quality and distinctive output and services

We note that, through its production activity, Studios plays an important role in providing the UK Public Services with a consistent supply of programmes which meet BBC audience needs, thereby contributing to this public purpose. Television accounted for approximately 53% of total TV licence fee spend in 2018 (£2,038m)⁶³, making it the most significant element of BBC activity in expenditure terms. The role of supplying high-quality television content is therefore fundamental to the BBC's main objective.

Studios' contribution towards this public purpose is evidenced by the industry recognition that its television and radio content has received. Studios produced over 2,000 hours of content in 2017/18, and received industry recognition with more than 80 awards and 200 nominations, more than any other producer in the UK. Studios produces content across a range of genres, including comedy, drama, entertainment and factual. It also produces content for a range of audiences, including titles aimed at a youth audience (16-34 year olds) – for example, the *One Love Manchester* concert, *The One Show*, *Strictly Come Dancing*, *EastEnders* and *Doctor Who*. Studios supports the UK Public Services in covering events of national significance, such as the *Royal Wedding* and *BBC Children in Need*, which reach global audiences.

Further, we note that Studios also financially supports content creation through up-front investment in programming for the BBC. In 2017/18, Worldwide generated returns of £210m to the benefit of the BBC Group (which included dividends and investments in programmes), above £200m for the fourth consecutive year. This return lowers commissioning costs and ensures continued access to premium content. For example, investment from Worldwide supported the launch of *Blue Planet II*, which reached an audience of 14 million, making it the most popular natural history programme in the last 15 years.

Public purpose 4: Reflect the diversity of the UK and support the UK creative economy

We have seen a number of examples which show that Studios seeks to reflect the diversity of the UK through its production, distribution and sales activities. At a high level, we note that Studios' editorial strategy for development is based around two distinctive themes: "*original perspectives and diverse voices*". Further, Studios' stated aim is "*to serve a UK that is becoming more and more diverse, and it will use its links to different parts of the country to champion diversity*"⁶⁴.

Programmes such as *Queers* and *This Farming Life* are two examples of shows which seek to illustrate the experiences and contributions of different groups with UK society. Studios has also historically played an important role in bringing people in the UK together to celebrate events such as the *Royal Wedding* and the *Silver Jubilee Concert*.

As a supplier of non-network content to the BBC, Studios' experience in non-network programming also assists in reflecting and supporting the on-screen representation of the UK's Nations and Regions. Local content in the past has covered consumer and topical issues in the Nations, including Wales' *X-Ray, 24/7*, and *Real Families*; Scotland's *The Ships that Made the Commonwealth* and *Pipers in the Trenches*; and Northern Ireland's *The Arts Show*. This combination of local and network programming has also led to the recognition of new talent in the UK's Nations and Regions in the past. For example, *Murdered by my Father* spotted new writing talent and gave them their first opportunity; *Defying the Label* was a critical part of the BBC's disabilities season; while *Citizen Khan* and the Comedy Feed *Dane's Dreams* both offered young comedians from ethnic minorities an opportunity to write or perform for the BBC.

Studios reflects the diversity of the UK by maintaining a geographic footprint which spans across the country. Studios' pan-UK presence brings both creative and logistic advantages. Its regional hubs allow the combination of national and local production, enabling a closer working relationship between network and non-network production. For example, the amalgamation of

⁶³ BBC, 11 July 2018, *Annual report 2017/18*

⁶⁴ BBC Studios, [online]. Available at: <https://www.bbcstudios.com/about/about-us/>

the *Doctor Who*, *Casualty* and *Pobol Y Cwm* teams in Roath Lock (Wales) since 2012 has stimulated growth in the creative services sector in Wales⁶⁵.

Within the creative economy, Studios has a number of partnerships across the UK, and has made progress in developing relationships beyond the BBC since its inception. Commissions such as *the Fatberg Autopsy* for Channel 4, *Inside Hotel Chocolat* for Channel 5 and *Cherry Healey's exploration of plastic surgery* for UKTV demonstrate Studios' ability to work with other companies in the industry, supporting the wider UK media ecosystem. In 2017/18, Worldwide made equity investments in three British independent drama production companies.

Public purpose 5: To reflect the United Kingdom, its culture and values to the world

Studios contributes to this public purpose by producing and distributing British content for international broadcasters. This allows Studios to promote the BBC brand internationally, and provides a UK voice within the global media industry. One of Studios' aims is to continue to develop creative content and formats to export and develop globally, reflecting the UK to the world.

A most recent example of UK content shared with a global audience is the launch by Studios of the 2018 series of *Doctor Who* in Africa at the first ever Comic Con Africa. *Doctor Who* is seen by Studios as a "quintessentially British show" and has been sold to over 239 territories since it began 55 years ago. It now has a large global following, with nine million fans across social platforms and 200 million video views on Facebook and YouTube⁶⁶.

The popularity of Studios' shows across the world can be seen through high ratings in 2017. *Planet Earth II* was the highest rating documentary of the year on the German public service channel ZDF, and was also the highest rating natural history programme of the year in Australia⁶⁷. *Blue Planet II* was New Zealand's highest rating finished programme, while *Sherlock* provided Russia's Channel One with its highest rating programme from the UK or US during 2017. In format sales, local versions of iconic British shows have also proved popular, such as *Dancing with the Stars* (the international version of Studios' *Strictly Come Dancing*), which is now licensed to 54 countries across the globe.

Proceeds from the distribution and sale of wholly-owned intellectual property also provide some added commercial content investment back to the BBC, better enabling the BBC to continue to commission content on a global scale. This builds on the BBC production team's track record for global hits including *Top Gear*, *Strictly Come Dancing*, and *Doctor Who*.

5.4.2 Global News

5.4.2.1 Test of appropriateness

As discussed in Section 5.2, to determine appropriateness we consider whether the activities conducted by Global News conflict with the mission and public purposes.

We have determined that by providing independent, impartial and trusted news around the world via TV, the internet and mobile, Global News' activities do not conflict with the BBC's mission and public purposes. Its activities are steered by editorial guidelines on impartiality, editorial integrity and conflicts of interest, ensuring that they do not conflict with the wider objectives of the BBC. Similarly, its editorial values demonstrate the organisation's commitment to trust and impartiality⁶⁸:

"The trust that our audience has in all our content underpins everything that we do. We are independent, impartial and honest. We are committed to achieving the highest standards of accuracy and impartiality and strive to avoid knowingly or materially misleading our audiences. Our commitment to impartiality is at the heart of that relationship of trust. In all our output we

⁶⁵ BBC Submission to the BBC Trust 4CC process for BBC Studios

⁶⁶ BBC Studios [online]. Available at: <https://www.bbc.co.uk/mediacentre/bbcstudios/2018/doctor-who-africa>

⁶⁷ BBC, [online]. Available at: <https://www.bbc.co.uk/mediacentre/worldwide/2018/bbc-worldwide-reveals-top-rating-shows>

⁶⁸ BBC, [online]. Available at: <https://www.bbc.co.uk/news/help-41670342>

will treat every subject with an impartiality that reflects the full range of views. We will consider all the relevant facts fairly and with an open mind."

The guidelines and principles of the BBC are embedded in the ways that BBC World News and BBC.com operate, and therefore are appropriate in relation to the mission and public purposes. As noted in the BBC's Annual Report 2017/18, given the current challenges in the media industry regarding fake news and misinformation, the BBC's role as a provider of accurate, impartial news is likely to be increasingly important⁶⁹. Therefore, continuing Global News' presence as a provider of impartial news across the world should be seen as an important aspect of fulfilling the BBC's mission and public purposes going forward.

In addition to the above, Global News invests in news programming and other content which is shown on the UK Public Services. For example, Global News funds *The Briefing*, *Newsday* and *World News*, all of which are broadcast live between the hours of 00:00 – 06:00 GMT on the BBC News Channel. In addition, Global News funds *World News Today* which is shown on BBC4. Global News also pays for a number of recorded programmes which are shown on the BBC News Channel, including *The Travel Show* and approximately fifteen documentaries each year.

5.4.2.2 Test of connectedness

We test the connectedness of Global News' activities below, by assessing how the subsidiary contributes to each of the BBC's public purposes, both financially and non-financially.

Public purpose 1: Provide impartial news and information to help people understand and engage with the world around them

As noted above, Global News provides news and information to audiences across the world, seeking to deliver journalism which is accurate, impartial, independent and fair. As shown in its strategy documents, the provision of impartial news and information is a core focus of Global News' strategy going forward.

Research shows that compared to other broadcasters, newspapers and online sites, the BBC is seen as the most trusted and impartial news provider in the UK⁷⁰. Approximately 57% of those surveyed by Ipsos Mori selected the BBC as the one news source they are most likely to turn to for news they trust the most⁷¹.

Outside of the UK, Global News has consistently been ranked as number one for trusted news, and seeks to remain the most trusted news provider in the medium term. In the United States BBC World News has been ranked as the top trusted TV news brand⁷². An additional online audience survey by the University of Missouri's Reynolds Journalism Institute found that the BBC was the fourth⁷³ most trusted source of news in the United States of America, ahead of local providers including the Wall Street Journal and Washington Post⁷⁴.

Public purpose 2: To support learning for people of all ages

We note that, through BBC.com, Global News directly supports learning for people of all ages, across a wide variety of subjects. Specifically, Global News operates a range of feature sites which aim to provide information on topics such as science, culture, travel, nature and history. These include:

⁶⁹ BBC, 11 July 2018, *Annual report 2017/18*, pg. 9

⁷⁰ BBC, [online]. Available at: http://www.bbc.co.uk/corporate2/insidethebbc/howwework/reports/trust_and_impartiality_2017

⁷¹ BBC, November 2017, *Public Trust in the BBC*, [online]. Available at: https://downloads.bbc.co.uk/aboutthebbc/insidethebbc/howwework/reports/pdf/bbc_report_trust_and_impartiality_no_v_2017.pdf

⁷² Brand Keys, Media Trust Tracker

⁷³ Following the Economist, Public Television and Reuters.

⁷⁴ Reynolds Journalism Institute, 25 July 2017, *Trusting News Project Report 2017*, [online]. Available at: <https://www.rjionline.org/reporhtml.html>

- ▶ **Culture:** which combines videos and images with editorial content from a host of well-known and respected journalists and commentators, offering perspectives on global trends across the arts;
- ▶ **Future:** which focuses on future trends in the areas of science, technology, environment and health. BBC Future's mission statement is "*making you smarter every day*". The website offers content regarding psychology, health, climate change and food – all seeking to provide new insights and informative content to readers;
- ▶ **Capital:** which is dedicated to offering a perspective on economic stories, trends and profiles on a personal level; and
- ▶ **Travel:** which is about all aspects of travel.

Public purpose 3: Show the most creative, high quality and distinctive output and services

Global News directly contributes to this public purpose through providing news content through both its TV and online channels.

The quality of Global News' journalism is evidenced through the international recognition it has received. For example, Global News won the 2018 Peabody Award in News for BBC World News' reporting of the Rohingya refugee crisis. The organisation also received 'Best News Programme' at the Asian Television Awards for *Newsday*, and 'TV News Story Of The Year' at the Foreign Press Association for the *Our World's Starving Yemen* documentary⁷⁵. Online, the BBC.com Culture feature site won a Webby for its social media presence and the Travel feature site won a Gold Lowell Thomas award for 'Best Travel Journalism' website⁷⁶.

Public purpose 5: To reflect the United Kingdom, its culture and values to the world

Global News directly supports this public purpose by providing independent news which seeks to reflect the UK and its values of accuracy, impartiality and fairness, to citizens of other countries⁷⁷. As shown in its strategy documents, the ambition of Global News to grow its global reach and reflect the United Kingdom across the world is embedded within its mission.

The channel is increasing its presence in the world, with its audience rising to 458 million households in 2017/18, up from 450 million in 2016/17⁷⁸. This growth has been driven by gains in Europe, the Americas and South Asia⁷⁹. Online, BBC.com received a monthly average of 1.3 billion page views each month across all platforms (website, apps and connected TV) in 2017/18.

The BBC's Global Audience Measure showed that BBC World News reached a global audience of 95 million per week in 2017/18, while BBC.com and social media platforms reached a global weekly audience of 37 million people⁸⁰. The international news service is now broadcast online and on TV in more than 40 languages.

5.4.3 Studioworks

5.4.3.1 Test of appropriateness

As discussed in Section 5.2, to determine appropriateness we consider whether the activities conducted by Studioworks conflict with the mission and public purposes.

⁷⁵ BBC, 11 July 2018, *Annual report 2017/18*, pg. 73

⁷⁶ BBC, 11 July 2018, *Annual report 2017/18*

⁷⁷ National Audit Office, 5 March 2018, *The BBC's commercial activities: a landscape review*, pg. 8

⁷⁸ BBC, 11 July 2018, *Annual report 2017/18*, pg.72

BBC, 11 July 2018, *Annual report 2017/18*, pg. 72

⁸⁰ BBC Global Audience Measure 2018

We consider that, by enabling the BBC, Studios and external producers to produce high-quality programmes in London and the South-East area, the activities of Studioworks do not conflict with the BBC’s mission and public purposes, and are therefore appropriate to be carried out.

The studio space provided at Elstree and Television Centre has been used to create high-quality and award-winning programmes for the BBC’s UK Public Services, such as those shown in Table 5. Programmes shown on the BBC channels represent a significant proportion of Studioworks’ activity, and constituted approximately 39% of Studioworks’ total studios revenue during the first 5 months of the 2018/19 financial year⁸¹. This proportion will increase in the second half of the year, due to the timing of productions such as *Strictly Come Dancing*. In addition, Studioworks has recently secured the productions *Have I Got News for You* and *Mock The Week*, which will further increase total revenue from BBC commissions.

Table 5: Examples of BBC programmes produced using Studioworks facilities

	Studios	Post production
EastEnders	✓	✓
Strictly Come Dancing	✓	✓
Children in Need	✓	✓
Pointless	✓	✗
The Graham Norton Show	✓	✗

The declining availability of studio space and post production facilities in the greater London area during recent years further highlights the important role which Studioworks has in the UK’s production market. As noted in Section 4, we do not currently observe a supply issue in the market for traditional TV studio facilities in London. However, given the decreasing availability of alternative studio space in Greater London (where close to 50% of BBC programming is made), there would be a substantial price and availability risk to the BBC, and to the wider market, if the capacity provided by Studioworks were not in place. This is most recently evidenced by the closure of London Television Studios in April 2018, which resulted in a number of BBC titles (including *The Graham Norton Show*) and ITV Daytime shows moving to Studioworks for production. The redevelopment of Riverside Studios, due to be completed in 2019, has also temporarily reduced the availability of appropriate facilities.

5.4.3.2 Test of connectedness

We test the connectedness of Studioworks’ activities below, by assessing how the subsidiary contributes to each of the BBC’s public purposes, both financially and non-financially.

Public purpose 1: Provide impartial news and information to help people understand and engage with the world around them

Studioworks has contributed to the production of high-quality news programming in the UK through its election broadcasting, which most recently took place for the General Election in 2017⁸². In doing so, Studioworks helped to facilitate the democratic process, an element outlined within the detailed description of the BBC’s first public purpose. *The General Election 2017 Special* was an overnight programme which was simulcast live from Studioworks’ Elstree Studio D, on BBC One, BBC News Channel and BBC World News.

The election programming incorporates modern technologies to enhance the viewer experience, with over 15 hours of political content, without a break. It is therefore among the

⁸¹ BBC Studioworks [online]. Available at: <https://www.bbcstudioworks.com/>

⁸² BBC Studioworks, [online]. Available at: <https://www.bbcstudioworks.com/political-broadcasting-studioworks-delivers-full-studio-technical-services-bbc-news-live-general-election-coverage/>

most technically complex and demanding broadcasts in TV production, and requires the full breadth of Studioworks' facilities and staff.

Public purpose 2: To support learning for people of all ages

We understand from interviews with Studioworks' personnel that the organisation provides services to producers of children's TV content, and also works with local educational institutions in order to inform students about the creative industry. Some staff within Studioworks provide advisory roles in local colleges to help create learning courses, while the studios also host a number of student visits. Studioworks takes on a number of trainees each year, and provides work experience, job shadowing and placements to the BBC apprentice scheme.

Public purpose 3: Show the most creative, high quality and distinctive output and services

It is evident from our review that Studioworks plays an important role in the value chain for the production of BBC output. In Elstree and Television Centre, Studioworks provides end-to-end services to production teams in fully-equipped studios and post-production offices, thereby facilitating the production process.

We note that the comprehensive service provided by Studioworks has produced award-winning shows across a range of genres for the BBC and other major production companies in the UK, such as ITV Studios. In 2018 for example, *Graham Norton* won the British Academy Television Award for Best Entertainment Performance, while *Strictly Come Dancing* won the Most Popular Talent Show at the National Television Awards.

Public purpose 4: Reflect the diversity of the UK and support the UK creative economy

Studioworks contributes to the fourth public purpose by providing studios and post production services to major TV broadcasters and production companies in the UK. Beyond the BBC's UK Public Services, this includes Studios, ITV, Sky, Channel 4, Channel 5, Endemol Shine Group, ITV Studios, Open Mike Productions, CPL Productions, Fulwell 73 and So Television. In 2017/18, more than 40% of Studioworks' revenue was from non-BBC customers.

The organisation therefore plays an important role in supporting the UK creative economy, by providing facilities, services and expertise which are not available elsewhere in London and the South East. This is most recently evidenced by the relocation of a number of ITV Studios programmes to Studioworks' facilities following the closure of The London Studios in April 2018. Studioworks provides the facilities, technology and teams to host ITV programmes such as *Good Morning Britain*, *Lorraine*, *This Morning* and *Loose Women* at Television Centre along with other successful studio productions such as ITV's *The Voice UK* live shows, *Britain's Got Talent*, *The Jonathan Ross Show*, and *Celebrity Juice*.

Further, we identified a case study where Studioworks used its technical expertise to support the wider industry – specifically the relocation of Channel 4 gameshow *Deal or No Deal* to The Bottle Yard Studios in Bristol⁸³. Over a period of a few months, Studioworks adapted a 3,000 square metre warehouse into a fully-functioning, self-contained studio and post production facility.

5.5 Conclusions and recommendations

Based on the findings for each commercial subsidiary, we consider that the BBC's commercial activities fit with the mission and public purposes. We have not identified any activities conducted by the BBC's commercial subsidiaries which are inappropriate to be performed in fulfilling the mission and in promotion of the public purposes. We have also observed that each of the subsidiaries contributes to one or more of the BBC's public purposes, with each of them directly, indirectly or financially connecting to four or more of the five purposes.

Going forward, it will be necessary for the BBC's commercial subsidiaries to demonstrate that the correct processes are in place in order to continue fit with the mission and public purposes.

⁸³ BBC Studioworks, [online]. Available at: <https://www.bbcstudioworks.com/our-work/consultancy/>

In addition, given the BBC's regulatory requirements, the organisation should ensure that appropriate documentation is in place to exhibit compliance with the first commercial criterion.

In light of this, we recommend the following:

- ▶ While the Agreement requires that commercial activities are appropriate to and connected with the mission and public purposes, these terms are not clearly defined – and there does not appear to be a consistent definition of these terms across the BBC. We consider that creating clear definitions for these terms would ensure consistent interpretation and application across the organisation.
- ▶ There is an opportunity to promote greater consistency across the subsidiaries in how fit with mission and public purposes is documented.

6. Exhibit commercial efficiency

6.1 Background

The Agreement defines a subsidiary's commercial activities as those which are “*undertaken with a view to generating a profit (regardless of whether the profit generated will or may be used to fund the fulfilment of the Mission or promotion of the Public Purposes)*”⁸⁴. Further, it notes that “*this means that something can be a commercial activity even if it also fulfils the Mission or promotes the Public Purposes, if it is done with a view to generating profit*”⁸⁵.

The Agreement further states that, alongside this review, “*the BBC must set and publish measures and targets for those measures for each subsidiary to assess whether the activity exhibits commercial efficiency subject to not jeopardising the ability of the subsidiaries to operate effectively in the market*”⁸⁶.

Ofcom's regulatory framework also requires the BBC's commercial subsidiaries to define and report: (i) forward-looking commercial rate of return targets on an annual basis; and (ii) financial performance on a quarterly basis⁸⁷. We set out these regulatory requirements in more detail in Section 8.

While the Agreement does not explicitly define commercial efficiency, we consider that a range of factors are relevant. Specifically, in order to exhibit commercial efficiency, we consider that each subsidiary must demonstrate:

- ▶ **Strategic direction:** Strategic direction is important to ensure businesses have the right focus, and understand their priorities and targets. Commercial businesses must therefore have in place – and execute – an appropriate strategy. The BBC should therefore be able to demonstrate that subsidiaries have a coherent and rational business strategy to drive commercial efficiency.
- ▶ **Budget planning and monitoring:** A robust approach to financial forward planning, and monitoring of actual performance against the plan is necessary to assess whether a business is operating in a commercially rational manner.
- ▶ **Investment appraisal:** The existence of a robust framework to govern the appraisal of investments, and/or a track record of successful investment, is one indicator of a business' commercial efficiency. Subsidiaries should demonstrate that they carefully appraise investments.
- ▶ **Earning a commercial rate of return:** While a business may make a loss or a return below market norms in the short term (for example, due to starting a new venture or undertaking investment), the business must earn a commercial rate of return over time if it is to be commercially efficient. Each subsidiary should earn a commercial rate of return. A commercial rate of return is defined as what a market operator would expect to achieve for a particular line of business. It should therefore act as a floor reflecting the level of return that an investor would expect to make in the market. This interpretation is in accordance with the BBC's response to Ofcom's consultation on the requirements and guidance around the BBC's commercial and trading activities.

⁸⁴ Agreement, Section 23 (2c)

⁸⁵ Agreement, Section 23 (2c)

⁸⁶ Agreement, Section 29 (2)

⁸⁷ Ofcom closed a consultation on the requirements and guidance around the BBC's commercial and trading activities on 24 September 2018.

6.2 Our approach

6.2.1 Overview

We have conducted a range of activities to determine whether each of the subsidiaries exhibits commercial efficiency. These are summarised below:

- ▶ **We reviewed and analysed a wide range of documentation, including:**
 - ▶ Internal documents prepared by the BBC, to develop an understanding of the forecasts and strategy for each subsidiary. These include reports prepared by the BBC's Corporate Finance Team that summarised the strategic and market context and provided an assessment of the commercial subsidiaries. The following subsidiary-specific documents were used:
 - ▶ Studios: the long-range merger business plan, and documentation detailing its strategy;
 - ▶ Global News: corporate strategy documentation, performance and reporting packs, market research reports and an impairment review; and
 - ▶ Studioworks: the three-year Studioworks budget submission, board meeting documentation and an impairment review.
 - ▶ Case studies provided by the BBC as supporting evidence of the main commercial subsidiaries adhering to BBC process, and of the BBC revising its processes based on lessons learned.
 - ▶ We are not aware of any other relevant case studies, beyond those for which information was provided to us, that would give rise to different conclusions with regards to the main commercial subsidiaries' investment appraisal framework.
 - ▶ Documentation provided to Ofcom for compliance and performance monitoring purposes, including the quarterly financial performance reports for 2017/18 and forward-looking rates of return for 2018/19 (plus supporting internal calculations).
 - ▶ Publicly available documents for historical information, including the annual reports of the BBC and Commercial Holdings, and the NAO's review of the BBC's commercial activities.
 - ▶ Documentary evidence of the process in place to secure commercial efficiency and the internal reviews conducted, including those relating to specific transactions and new business ventures.
- ▶ **We conducted benchmarking analysis to assess the BBC's targets and financial performance:**
 - ▶ We reviewed the BBC's benchmarking analysis that informed the measures (and the targets for those measures) that it submitted to Ofcom.
 - ▶ We considered the extent to which the BBC's choice of measure is appropriate to determine commercial efficiency, and conducted our own benchmarking analysis for each line of business. This analysis gives an indication of whether the BBC's targets and achieved results are in line with those of a comparator set of organisations.
 - ▶ For the purpose of this review, we consider that a subsidiary is earning a commercial rate of return if its return is within, or projected towards, a market range.

The activities above were underpinned by the four elements of commercial efficiency identified in Section 6.1. Our approach to assessing these for the main commercial subsidiaries are described in turn below.

6.2.2 Strategic direction

We appraised whether the BBC was able to demonstrate that the main commercial subsidiaries have a coherent and rational business strategy.

6.2.3 Budget planning and monitoring

We reviewed the subsidiaries' respective financial planning processes and the latest set of business plans. We summarised and reviewed recent financial performance, focusing on the three measures of performance that the BBC's main commercial subsidiaries report to Ofcom annually – revenue, profitability, and free cash flow (post-interest and tax) ("FCF").

We reviewed the accuracy of forecasting by comparing each of the subsidiaries' historical forecasts with actual performance. For the purpose of our review, we considered each data point within the forecasts and evaluated the proportion of forecasts that were within 5% of actuals as an indicator of accuracy.

6.2.4 Investment appraisal

We conducted interviews with BBC personnel and reviewed relevant case studies in order to understand the BBC's processes for reviewing performance and appraising investments.

6.2.5 Earning a commercial rate of return

6.2.5.1 Measuring rate of return

Ofcom requires the BBC to assess what an appropriate commercial rate of return is for each line of business, including monitoring and researching the markets in which it operates, to ensure that the returns generated by its commercial activities are in line with market norms. Ofcom does not specify the rate of return measure that it expects the BBC to use, and this measure is determined by the BBC. The rate of return measure is important, as it is a headline measure used to assess whether a subsidiary is making a commercially sustainable level of return, a key consideration in the assessment of the exhibition of commercial efficiency.

We have considered three potential metrics to be used to measure the commercial rate of return:

- ▶ **EBITDA margin:** Defined as EBITDA divided by Sales. EBITDA margin is the measure chosen by the BBC to measure the rate of return earned by the commercial subsidiaries;
- ▶ **EBIT margin:** Similar to EBITDA margin, but accounts for depreciation and amortisation; and
- ▶ **Return on capital employed ("ROCE"):** Shows how efficiently a firm uses its capital structure, (i.e. the mix of debt and/or equity used to finance its assets and operations) to generate revenue.

The BBC focuses on EBITDA margin in the range of internal documentation reported to the BBC Board as part of the budget planning and monitoring process of the commercial subsidiaries, which is outlined in Section 6.2.1.

We note that businesses may use a wide range of other profitability measures, including other asset-based measures like Return on Investment, as well as dividing profit (before or after tax) by revenue to deliver profit margins. Given that other profitability measures are effectively variants of those set out above, we have restricted our analysis to EBITDA margin, EBIT margin and ROCE.

We provide an appraisal of the BBC's choice of EBITDA margin as its metric to measure the rate of return earned by its commercial subsidiaries in Section 6.3.4.1 below.

6.2.5.2 Benchmarking

For the purpose of this review, we consider that a subsidiary is earning a commercial rate of return if its return is within, or projected towards, a market range in the current business planning period. As such, we conducted benchmarking analysis to compare the BBC's financial performance against relevant comparator organisations. Our method for selecting these organisations was as follows:

- ▶ Based on our knowledge and understanding of the market, we listed a set of organisations that may undertake similar activities to each of the subsidiaries' lines of business.
- ▶ We used Capital IQ⁸⁸ to obtain relevant, historical financial information to calculate the EBITDA margins of these organisations.
- ▶ Additionally, we input criteria matching the activities of each of the subsidiaries' lines of business into Capital IQ in order that it suggested further potential comparator companies, along with their relevant financial information.
- ▶ We reviewed the financial statements of the comparator organisations to:
 - ▶ Verify the Capital IQ figures where possible;
 - ▶ Strip out elements from the financials for segments performing non-comparable activities to the extent possible; and
 - ▶ Assess in closer detail whether the activities of the comparator organisations were comparable to each of the subsidiaries' lines of business, eliminating those that were not. Ideally, we would benchmark against organisations carrying out identical functions and/or with exactly the same business models as the BBC's commercial activities. Despite the difficulty in identifying such organisations, as well as data limitations, we have sought to identify organisations which are as similar to the BBC's commercial activities as possible, to allow us to calculate an indicative range of margins for comparison to each of the subsidiaries' lines of business, in the context of the market and their specific circumstances. As a result, the size of the sample (the number of comparator organisations included in the analysis) is small in a number of cases.
- ▶ We then applied revenue thresholds in accordance with the scale of revenues for each of the subsidiaries' lines of business, to exclude organisations of vastly differing scales. Significantly larger organisations may not be comparable if they have particularly strong market positions, while very small organisations are unlikely to be able to generate the economies of scale required to be comparable.

As the BBC has chosen EBITDA margin as the metric to measure its commercial rate of return, we have benchmarked EBITDA margin against comparator organisations to the main commercial subsidiaries lines of business. We have assessed the reasonableness of using EBITDA margin as a benchmarking metric and the relative benefits of other measures in Section 6.3.4.1 of this report.

In calculating the EBITDA margins for each of the organisations listed above, where relevant and practicable we have sought to align the accounting treatment to the BBC's accounting policies⁸⁹. As making adjustments to figures in audited accounts risks subjectivity, we have

⁸⁸ Capital IQ is a platform owned by S&P Global that combines global financial data with company and industry research.

⁸⁹ The BBC defines EBITDA margin as statutory operating profit, with the following operating expenses added back: (i) depreciation; (ii) non-content-related amortisation; (iii) impairments/write-downs. In calculating EBITDA, the BBC also offsets costs with tax credits, which aligns to market practice.

exercised caution when doing so, and avoided making assumptions which are not based on observable and objective information. It should be noted that there may be other differences in accounting treatment that have not been identified or are not disclosed in comparators' accounts.

Our analysis assesses the actual and forecast financial performance of the main commercial subsidiaries, comparing these to identified comparator organisations' historical financial performance. We have grouped the benchmarked companies such that they align with each of the main commercial subsidiaries' lines of business. We have used EY's benchmarking sources to obtain revenue and EBITDA data for four years (2014 to 2017) for these organisations (where available).

We have compared the EBITDA margins of the benchmarked companies against the main commercial subsidiaries' respective 2017/18 financial results, as well as their forecast financial results to 2020/21 (2021/22 for Studios as its business plan contains more forward-looking information). As our analysis includes four years of historical values for the comparator companies, we have calculated weighted averages for the EBITDA values for the comparator groups, using sales figures to weight the average. The weighted averaging method treats the entire period of reported data as occurring in one accounting period, which consequently reduces the effects of anomalies in the data that may arise during atypical years of operations (e.g. due to adverse economic/market conditions).

The weighted average figures for the companies are then used as the basis for calculating interquartile ranges of results achieved by the groups of benchmarked companies, where the sample size allows⁹⁰. In an interquartile range, the first quartile is the value below which 25% of the observed values are located. The third quartile is the value above which 25% of the observed values are located. The median is the value below and above which 50% of the observed values are located. The interquartile range indicates the most typical and representative values of a tested variable because at least 50% of the results are included in the range. We therefore used the interquartile range for the purpose of comparison.

We recognise that benchmarking may have some limitations in determining whether an organisation is commercially efficient. For instance, comparator organisations may be at different stages of development (e.g. Studios has only recently been established as a merged, vertically-integrated content business, with the synergies from that merger yet to fully materialise), and like-for-like comparable information may be difficult to identify or calculate⁹¹. In particular, many comparator businesses to the BBC are reportable segments rather than whole organisations, the former of which do not require a statutory profit definition. For example, ITV defines a measure of adjusted EBITA (defined as earnings before interest, tax and amortisation) at segment level, rather than unadjusted operating profit. There are limitations of company disclosure and reliance on filed subsidiary accounts, meaning that corporate cost allocations may not be captured in some cases, which would inflate the margins recorded by these comparators. Furthermore, EBITDA is not a statutory measure, so may be reported differently by different companies (incorporating some adjustments for exceptional items). This needs to be considered, as far as possible, by taking statutory operating profit and adjusting for depreciation and amortisation.

⁹⁰ At least six benchmarked companies are needed for a meaningful interquartile range. Where the sample size is below six, we simply consider the full range.

⁹¹ In this context, we also note that benchmarking is inherently backward-looking. Therefore, we do not make assumptions about changes that may occur to the benchmarked ranges.

There are also other factors for which benchmarking does not account (such as market context and the characteristics of each particular company), which we consider when assessing whether a business is earning a commercial rate of return. These include differences in history, business models, scale, geography, markets, strategy, M&A activity and financing structures. Similarly, there are reasons specific to the BBC which may drive differences between returns earned by the commercial subsidiaries and comparator organisations. For example, every BBC commercial subsidiary must have regard to fit with mission and purposes (although this should not conflict with the requirement to exhibit commercial efficiency), and each subsidiary has inherited significant pension scheme costs, which are not controlled by the commercial subsidiary and may exceed those of comparators.

We therefore consider it reasonable to use benchmarking to provide an indicative range that enables an organisation to assess its performance and targets, but recognise the importance of these other factors in providing context to the benchmarking results.

6.3 The BBC's approach to commercial efficiency

The BBC has a range of budgeting, forecasting and governance processes in place to assess whether its commercial activities exhibit commercial efficiency. Each of the main commercial subsidiaries defines its strategic priorities, and prepares financial performance targets on which it reports performance to the Board and Ofcom annually. The BBC also incentivises the main commercial subsidiaries' management based on commercial performance.

6.3.1 Strategic direction

The BBC Board sets the overall strategy for the commercial subsidiaries, which is exercised via the Commercial Holdings Board. The Commercial Holdings Board has clear procedures and delegations in place with each subsidiary, which determine what the executive committees in each subsidiary are authorised to do. These are determined on the basis of thresholds varying by the entity and type of investment.

6.3.2 Budget planning and monitoring

6.3.2.1 Historical financial performance

The BBC has chosen metrics to measure its revenue, profitability and cash flow. Each commercial subsidiary defines an annual target for each of these metrics. The chosen metrics are:

- ▶ **Revenue:** The revenue metric is per the statutory definition of sales – a measure similar to “headline sales” (a sales item defined by Studios), with minor adjustments such as excluding revenues from joint ventures⁹².
- ▶ **Profitability:** The measure of profitability chosen is EBITDA. The intention of this is to illustrate an underlying profitability that can be benchmarked relatively easily and gives a reasonable base from which to link through to cash flow measures (i.e. minimising the incorporation of non-cash accounting policy adjustments into profitability).
- ▶ **Cash:** FCF is used to measure cash flow. This incorporates all non-discretionary payments necessary to operate a business, and has been chosen by the BBC to represent what a business is able to generate after spending the money required to maintain or expand its asset base. It also represents the cash flow generated by a business that is ‘free’ to pursue discretionary opportunities that enhance shareholder value.

6.3.2.2 Forecast financials

The BBC produces annual budget packs for each subsidiary, setting out forecast financial information for three to four years. The forecast metrics include revenue and EBITDA.

⁹² The BBC has stated that its intention is to drop the ‘Adjusted’ title from the Adjusted Sales measure to simply use Sales as the revenue target, as it currently uses the latter measure (which is statutory) for the most part anyway.

6.3.2.3 Financial performance monitoring

The BBC reports the following for each of its main commercial subsidiaries: (i) financial performance on a quarterly basis; and (ii) forward-looking commercial rate of return financial targets on an annual basis.

► **To the BBC Board:**

- **Quarterly financial reports**⁹³: The BBC produces quarterly board reports, assessing year-to-date and full year forecasts against targets for revenue, EBITDA and FCF. The analysis also identifies reasons for variances that are specific to each line of business. These regular checks on the financial performance of the business, and the factors affecting this performance, aid the BBC's ongoing understanding of the commercial subsidiaries' performance⁹⁴.

► **To the Commercial Holdings Board:**

- **Regular subsidiary-level reports**: The BBC submits information for each subsidiary for review by the Commercial Holdings Board. These contain the same figures as those in the quarterly financial reports to the BBC Board, so the two boards have oversight of the same numbers. Please refer to Sections 6.4.2.3, 6.5.2.3 and 6.6.2.3 for further details of these reports.

► **To Ofcom:**

- **Quarterly financial reports**: The quarterly financial reports submitted to the Board are also submitted to Ofcom⁹⁵.
- **Annual commercial rate of return targets**: The BBC is required to inform Ofcom annually of the forecast commercial rates of return for each subsidiary and line of business (refer to Section 6.3.4.1). Ofcom will assess the level of return by considering whether a rational private investor would invest in the activity given the level of risk. In the event that the actual rates of return for a line of business fall below those targeted, as soon as practicable the BBC must provide Ofcom with an explanation of the planned steps to get back to target and when this is expected to occur (including supported planning and budgetary information).

Internal subsidiary-specific reporting in addition to that to the Commercial Holdings Board is outlined later in Section 6.

The BBC also monitors the FCF of its commercial activities to understand the impact on its borrowing requirements, as the Secretary of State has set an aggregate limit on its net borrowing for commercial purposes of £350m. The BBC borrows for commercial activities through Commercial Holdings, which then on-lends to the main commercial subsidiaries. Commercial Holdings has a revolving credit facility with a group of six international external banks, and a US private placement. Considering peak net debt levels in each given year, the BBC did not get close to reaching the £350m net borrowing limit for its commercial activities during the period 2012/13 to 2017/18.

The BBC does not currently plan to request an increase to the Commercial Holdings' net borrowing limit unless required to do as a result of changes to financial reporting standards (that will not uniquely impact the BBC)⁹⁶. The BBC has carried out some benchmarking and found that peers tend to achieve higher levels of net debt/EBITDA leverage than what is implied by a £350m limit. Although the BBC has not been close to reaching its commercial net borrowing limit in recent years, we understand from the BBC that a number of factors have contributed to this. The fact that exceeding the limit would be a breach of the Charter has led

⁹³ BBC, June 2018, *Board report*

⁹⁴ The reports also include analysis of the financial performance of the BBC Group as a whole.

⁹⁵ Only the analysis specific to the commercial subsidiaries are submitted to Ofcom.

⁹⁶ For example, the introduction of IFRS16.

to a traditionally conservative approach in adhering to the limit. An example of this is that there is a 'double' headroom imposition: Commercial Holdings requires a set level centrally, and each subsidiary also does the same to ensure it does not breach its individual allocation. Further, dividends have been retained by Commercial Holdings to reduce interest payments by the BBC Group to external parties, by reducing its revolving credit facility⁹⁷ at times when the BBC holds a strong cash balance. However, even if the subsidiaries were pushing their commercial borrowing limits, they would still not have the financing flexibility of some peers. As discussed in Section 4, certain markets have been disrupted by players with large balance sheets and financing power, and the borrowing limit may represent a disparity between such organisations and the subsidiaries in the future.

6.3.3 Investment appraisal

For a commercial subsidiary to obtain approval for a given investment or venture, the Board of the commercial subsidiary in question must produce a proposal, setting out at least three years of forward-looking financial data. Studios' ventures tend to be the largest of the commercial subsidiaries. The majority of those that are considered by the BBC Board are therefore put forward by Studios. The target hurdle rate used for each case may vary and is considered alongside a number of factors (including analysis of Weighted Average Cost of Capital).

6.3.4 Earning a commercial rate of return

6.3.4.1 Measuring rate of return

As noted in Section 6.2.5.1, the BBC focuses on EBITDA margin in the range of internal documentation it reports to the BBC Board as part of the budget planning and monitoring process of the commercial subsidiaries.

Ofcom requires the BBC to assess what an appropriate commercial rate of return is for each line of business, using a metric determined by the BBC. We appraise three such potential metrics below, including the BBC's chosen metric of EBITDA margin.

► EBITDA margin:

- The BBC has indicated that it chose EBITDA margin as its metric to measure the rate of return earned by its commercial subsidiaries because it provides a good indicator of underlying profitability and is closely correlated to the cash earned by a business, which is clearly critical to continued operation. Differences in accounting policies can cause depreciation and amortisation to distort profitability; using EBITDA margin avoids this issue. Furthermore, EBITDA is a commonly used internal measure in the industry, and is also used by external analysts.
- We agree that EBITDA is an appropriate metric: it is widely used and relatively easily comparable to industry competitors. However, EBITDA margin has some drawbacks. For instance, because it does not reflect levels of depreciation and amortisation, there is a risk that it masks lossmaking once these costs are factored in. Further, it is not a statutory accounting measure and often must be calculated manually for benchmarking purposes, by starting with EBIT and adding back the depreciation and amortisation figures. There is therefore a risk that, where companies have categorised accounting items differently, the comparability of calculated EBITDA figures across companies is reduced. For example, where one company classifies the reduction in the value of a particular asset as amortisation, another may classify it as an operating expense. In this case, if the asset value reduction was not separately distinguished from other items comprising the amortisation, the amount would be added back to arrive at the EBITDA figure for the first company, but not for the second.

⁹⁷ A revolving credit facility is a flexible loan that is used in a similar manner to an overdraft. Having less of it drawn down allows for reduced interest payments.

► **EBIT margin:**

- EBIT is less descriptive of the underlying profitability of the core operations of the business, and of the ability for it to generate cash, than EBITDA, as it includes depreciation and amortisation, for which businesses may choose different accounting policies⁹⁸. However, the advantage of this is that depreciation and amortisation provide some measure of depletion of assets' productive capability and the need for replenishment. Tracking EBIT margin over time therefore carries less risk of masking a business which is making an overall loss on an ongoing basis.
- Additionally, EBIT is a more commonly publicly reported measure, meaning that the data required to benchmark EBIT margin can be more readily available than that for EBITDA margin. This is because at company level, EBIT is a statutory measure. At segment level, while there is no statutory requirement to report EBIT, it is often the chosen measure of profitability reported.
- Nevertheless, it is important to note that the BBC monitors FCF in conjunction with EBITDA margin. This measure includes the deduction of capital expenditure and working capital, and therefore separately captures the investment in and usage of assets. This eliminates much of the relative benefit of using the EBIT margin to using the EBITDA margin. It is therefore appropriate for the BBC to use a combination of EBITDA margin and FCF to assess the returns earned by each of the subsidiaries' lines of business.

► **ROCE:**

- ROCE is linked to the concept of economic profit. A firm is deemed to make a "normal return" if the revenue it receives is equal to the sum of both the accounting costs and the opportunity cost of the capital invested in the business.
- However, within the media industry, it may be difficult to identify relevant benchmarks for ROCE due to the differences in capital structure across companies. In particular, the level of ownership of studio facilities and other high value, long-life assets may make it impossible to compare with a media company that solely rents studio space. ROCE is rarely used by media companies or industry analysts, suggesting it is less relevant and making benchmarking more difficult. With this metric, any benchmark set for media companies would need to be designed around those with a similar capital structure, which may not be possible.

For the purpose of this review, we consider that EBITDA margin is an appropriate measure of profitability.

6.3.4.2 Benchmarking

Prior to the preparation of our benchmarking analysis, the BBC carried out its own benchmarking study. The BBC's analysis focuses on a narrower set of comparator organisations, at a single point in time for each one identified (i.e. considering the most recent data point).

We have generally sought to include the comparator companies identified in the BBC's study in our own analysis. Despite the different methodologies, the results of the two analyses do not significantly differ.

⁹⁸ Different accounting policies could have distortionary effects. This is best illustrated by considering an example of two identical businesses, where one has more cautious accounting policies than the other. The former assumes that it will use up its assets more quickly than the latter, and will thus have higher depreciation and amortisation costs in each year. It would therefore have a lower EBIT margin, despite its underlying profitability (and EBITDA margin) being no different to the other business.

6.4 Studios

6.4.1 Strategic direction

6.4.1.1 Strategic priorities and developments

Studios provided us with a summary of its strategy, setting out three strategic priorities for the new combined entity, as well as its financial targets. We have not seen any other materials that specifically document Studios' strategy, but we understand through interviews with Studios executives and Commercial Holdings Board members that Studios has defined and is implementing a commercial strategy. Examples of recent strategic developments within Studios are the appointment of a new Director of Content to oversee the editorial strategy for UK production, and the creation of a new role to lead on some of Studios' major titles. Studios also regularly makes strategic acquisitions to aid its distribution business.

6.4.1.2 Merger appraisal

We also reviewed a paper that was submitted to the BBC Board in October 2017, outlining the rationale for the merger of legacy Studios and Worldwide. This paper included financial forecast comparisons (with and without the merger), consideration of the similarity of all key competitors' structures, sources of synergies and a materiality assessment. In light of these considerations and legacy Studios' experience in similar corporate restructurings through acquisitions of independent companies and joint ventures, the merger was approved. This paper demonstrates that the commercial rationale of the merger was analysed, with the Commercial Holdings Board attempting to take steps to achieve commercial efficiency in respect of Studios from prior to its inception.

6.4.2 Budget planning and monitoring

6.4.2.1 Historical financial performance⁹⁹

As Studios was formed in 2017/18, there is no directly comparable historical financial information to compare to current performance. For context, we provide an overview of Worldwide and the legacy Studios entity in this subsection.

► Revenue

- Prior to the merger with the legacy Studios, Worldwide generated the vast majority of the BBC's commercial revenue (approximately 90%). Worldwide's revenue increased from £855.4m in 2015/16 to £868.3m in 2017/18, an increase of 2%.
- The legacy Studios entity was not a commercial corporation until 2017/18. Using a pro forma that allows for consolidation adjustments, Studios' 2017/18 revenue can be calculated as £1.3bn¹⁰⁰.

► Cash flow

- Worldwide monitored its cash flow in order to remain in line with its borrowing limit.
- Legacy Studios' and Worldwide's peak net borrowing increased from £114m in 2015/16 to £153m in 2017/18. These amounts were within the combined portion of Commercial Holdings' £350m net borrowing limit allocated to the entities, which was £172m in 2015/16 and £270m in 2017/18.

► Profitability

- Similarly to revenue, Worldwide produced most of the BBC's commercial profits in recent periods. Its adjusted operating profits decreased from £123.9m in 2015/16 to

⁹⁹ National Audit Office, 7 March 2018, *The BBC's commercial activities: a landscape review*

¹⁰⁰ Pro forma figures for the combined entity are a proxy measure provided by the BBC, calculated using audited figures only from Worldwide's and legacy Studios' financial statements. The pro forma measure itself has not been audited and no audited pro forma data currently exists on the merged Studios entity

£100.6m in 2017/18. During this period, Worldwide's profits constituted more than the commercial subsidiaries' profits combined, as the other entities were loss-making at the operating margin level.

- ▶ Worldwide made dividend payments of £423m over this period.
- ▶ Studios' pro forma¹⁰¹ 2017/18 EBITDA can be calculated as £109.7m, which represents an EBITDA margin of 8%.

6.4.2.2 Forecast financials

Prior to Studios' merger, the Commercial Holdings Board prepared a budget for 2018/19 and a long range plan to 2021/22 for Worldwide and legacy Studios, which includes forecast financials for the merged entity.

These forecasts include strong growth in revenue, EBITDA and FCF. Collectively, these forecasts suggest that Studios will reduce its cost base and/or achieve a higher margin on its activities. Studios highlights that these forecasts will be aided by merger synergies. These synergies are relatively small compared to the growth budgeted. Therefore, the sources of significant increases in revenue and EBITDA are not immediately clear from the documentation we have reviewed.

There are risks to these forecasts identified in the budget plan. For example, there is a risk that Studios will not win all of the titles that it forecasts to during this period, and some costs may be underestimated. These factors may erode Studios' profitability going forward.

That said, we have reviewed the accuracy of Worldwide and legacy Studios' forecast financials. Of the 15 data points forecast¹⁰² for 2016/17 and 2017/18, only one exceeded the actual result by more than 5%. Looking further back, since 2012/13, more than half of data points forecast have been below actuals by more than 5%. This analysis suggests that Studios' forecast financials are generally conservative, and we therefore consider that the approach to forecasting is reasonable.

6.4.2.3 Financial performance monitoring

Studios reports annual forward-looking rate of return targets to Ofcom. Please refer to Section 8.5 for further details of this process for 2018/19.

The BBC produces quarterly financial reports for Studios, for review by the Commercial Holdings Board. These include year-to-date figures, comparisons to budget, and explanations of variances. The reports also contain analysis of net debt, an income statement, staff costs and the revenue intellectual property mix¹⁰³. There is also a reconciliation between the EBITDA figure reported in the pack and the figure reported to Ofcom.

The BBC also produces monthly financial reports analysing sales, EBITDA and cash flows (including FCF) for Studios¹⁰⁴. These include year-to-date figures, comparisons to budget, and explanations of variances. Analysis is conducted at a more granular level than line of business. The reports also contain analysis of net debt, an income statement, and regional distribution results.

¹⁰¹ Pro forma figures for the combined entity are a proxy measure provided by the BBC, calculated using audited figures only from Worldwide's and legacy Studios' financial statements. The pro forma measure itself has not been audited and no audited pro forma data currently exists on the merged Studios entity

¹⁰² The data points forecast include sales, EBITDA, FCF, dividends, net debt and returns to the BBC. This is across both Worldwide and legacy Studios for 2017/18.

¹⁰³ This sets out how much revenue is derived from BBC existing, new, and third party intellectual property, and secondary income.

¹⁰⁴ BBC Studios, June 2018, P3 SEC Pack

6.4.3 Investment appraisal

We have considered the following case studies to understand the BBC's governance and investment appraisal processes for Studios:

1. Worldwide's Investment Guidelines, Discount Rate Framework and Post Investment Review process;
2. Sale of a stake in BBC America to AMC Networks;
3. The BBC's transformation of its in-house production unit into a wholly owned commercial subsidiary of the BBC, creating the legacy Studios; and
4. The launch and subsequent closure of the online television content platform BBC Store.

The first three case studies act as examples of the governance and investment appraisal processes in action, while the final case study is an example of how the BBC takes action to stop activities if it deems them to be commercially inefficient.

▶ **Case study: Worldwide's Investment Guidelines, Discount Rate Framework and Post Investment Review process**

- ▶ One of the key controls that Worldwide had in place to ensure its investments were commercially efficient was the set of Investment Guidelines that Worldwide had in place, which set out the process for scrutinising and approving investments.
- ▶ The guidelines sought to ensure that the right information was considered prior to any investment taking place by requiring the calculation of investment returns and business plan sensitivities. The Investment Guidelines also set out financial metrics by which an investment decision was assessed, including relevant benchmarks or comparators to provide context and assist the investment decision.
- ▶ The guidelines also set out the governance structure for investment approvals. They sought to ensure relevant internal stakeholders – for example, Regulatory Affairs, Commercial Finance, Corporate Legal and Business Affairs, Tax and Strategy – were able to review key commercial terms, the business plan, sensitivities and risks prior to any investment taking place. The guidelines also set out the relevant approval bodies in place to scrutinise investments, depending on the nature, strategic significance and materiality of the investment. For example, an investment in a new channel launch over £1m was required to be first approved by the Investment Review Group.
- ▶ Worldwide also had in place a Discount Rate Framework, used for calculating investment discount rates that can be tailored to each investment. The discount rate was applied to the projected investment cash flows to calculate the net present value ("NPV") across the projected period, typically five to ten years. Sensitivities are presented around the business plan to allow the reviewer to assess the viability of the investment case on a range of discount rates and to key business plan drivers.
- ▶ Finally, Worldwide has a Post Investment Review process, where actual investment performance was regularly reviewed and compared to expected performance at time of investment.
- ▶ Our understanding is that the processes that were in place at that time are followed by the current Studios entity. Combined, these processes and controls aim to ensure that the investment decision-making process is robust and aligned to the strategy for growth and allocation of capital. They are intended to constitute a comprehensive safeguard for ensuring that investment decisions are commercially efficient.

► **Case study: BBC America**

- In 2014, Worldwide sold a 49.9% stake in BBC America to AMC Networks (a US-based cable network). The final deal documentation for the partnership contained a 4CC report prepared by the BBC Fair Trading team, and outlined the valuation process which underpinned the commercial efficiency criterion.
- The BBC engaged an independent company to value BBC America as a standalone entity, and to compare this valuation with the valuation of the joint venture resulting from the AMC Networks offer. The valuation of the joint venture considered the upfront consideration, the brand fees, cost savings, synergies and tax implications. The valuation demonstrated that, even if no synergies were realised, BBC America was better off in the partnership than outside it.
- The BBC engaged external advisors to provide an independent fairness opinion review on the partnership, in order to judge that that transaction had taken place at fair value. No material issues were identified in the review, and the fairness opinion letter was subsequently issued in October 2014.
- The BBC also conducted further detailed analysis, including comparable companies, precedent transactions and more detailed tax implications.
- After consideration of the factors described above, the Board concluded that the BBC America transaction represented reasonable value for the BBC, and that there were sufficient risk mitigations, such that it exhibited commercial efficiency.

► **Case study: 2016 Commercialisation of Studios¹⁰⁵**

- The BBC evaluated the case for commercialising the legacy Studios against the 4CC framework. In doing so, the BBC focused on (i) prospective financial performance and (ii) governance and oversight. The depth and breadth of the review appears sufficient to effectively ensure commercial efficiency is being exhibited.
- The BBC sought independent financial advice and assurance to test its conclusions on the commercial efficiency of the proposed legacy Studios business. The scope of this work included: a financial review of the five-year business plan (including sensitivity analysis); and an economic and commercial review that looked at legacy Studios from the perspective of a market investor.
- On governance, the BBC proposed a range of financial oversight mechanisms, including: regular financial reporting to the BBC Board; a quarterly business review with the Deputy Director General; annual budget and objective setting meetings with the Deputy Director-General; overall budget and objective approval from the BBC Board; and annual going concern review by Commercial Holdings Board and the BBC's auditors.
- The BBC Trust, with EY as advisors, reviewed business plans submitted by the BBC, and the reports submitted by the BBC's independent advisors, in September 2016. The Trust concluded that legacy Studios' commercialisation would meet the commercial criteria, but recommended that the BBC should set annual commercial performance targets and monitor performance at appropriate points in the year. This recommendation has been implemented, and forms part of Ofcom's regulation of the main commercial subsidiaries today.

► **Case study: BBC Store**

- BBC Store, launched in November 2015, was a platform that allowed UK residents to purchase, download and own digital copies of BBC shows. Prior to the launch of

¹⁰⁵ BBC Studios, August 2016, *4CC Main Case*

BBC Store, the BBC Board assessed the proposed investment's compliance with the 4CC framework. It outlined five objectives and a number of expected benefits associated with each objective, and included financial projections indicating positive cash flow in year 3 and positive profit before interest and tax ("PBIT") in year 4.

- ▶ The pre-launch spend on BBC Store was £17.4m and the forecast payback period was 13 years, longer than previous BBC investments¹⁰⁶. This spend was regularly reviewed between approval and launch, and the BBC applied additional levels of editorial, marketing and fair-trading scrutiny during the approval stages. However, by the time BBC Store launched, consumer demand was already moving towards streaming services, meaning that the demand for archived content was lower than predicted¹⁰⁷. As a result, by March 2017, sales were substantially lower than plan, significant losses of approximately £5m p.a. were being incurred, and the BBC Store board paper stated that a path to breakeven point was unclear¹⁰⁸.
- ▶ The BBC considered ways of making BBC Store commercially viable following its worse-than-expected financial performance – for example, by increasing promotion of the BBC Store on iPlayer, reducing the BBC Store service to a minimum, or by exploring potential partners for BBC Store to reduce costs and/or grow revenue. However, the BBC announced in May 2017 that it would close BBC Store, following the approval of the BBC Board. The closure resulted in Worldwide writing off £12.5m in 2016/17.
- ▶ Prior to (and independently of) the closure of BBC Store, the BBC highlighted a number of lessons, based on its experiences with the investment. The case of BBC Store is an example of the BBC monitoring financial performance on an ongoing basis, as well as changing its commercial strategy as necessary in order to generate the most beneficial financial outcome.

6.4.4 Earning a commercial rate of return

The BBC has conducted a benchmarking study and reported target measures to Ofcom, classifying identified comparator organisations by Studios' lines of business. As a result of the lack of comparable organisations for UK Productions, International Productions and Content Sales, the BBC grouped these individual lines of businesses together for the purpose of benchmarking. We agree with and have followed this approach in carrying out our own benchmarking exercise. Studios' lines of business' actual and forecast EBITDA margins can be compared to the benchmarking results, to give an indication as to whether its lines of business are earning a commercial rate of return.

We understand that the BBC has highlighted that, among Studios' lines of business, Consumer Products is the most difficult for which to find organisations performing comparable activities. Based on our own analysis, we agree with this observation, and note that the level of comparability of this set of organisations to the BBC's commercial activities is therefore likely to be lower than that of the other sets. That said, we have conducted indicative benchmarking analysis in order to enable a comparison with the forecast EBITDA margin for Consumer Products. We consider that Consumer Products is likely to continue to represent a difficult area to benchmark going forward and is a declining part of Studios' business.

¹⁰⁶ BBC Worldwide, March 2017, *BBC Store: investment review and way forward*

¹⁰⁷ National Audit Office, 7 March 2018, *The BBC's commercial activities: a landscape review*

¹⁰⁸ BBC Board, March 2017, *BBC Store*

6.4.4.1 Comparator organisations and benchmarking results

The sets of comparator organisations are listed in Table 7.

**Table 6: List of comparator organisations for Studios
Production and content sales¹⁰⁹**

All3 Media
Entertainment One (Television segment, excluding Mark Gordon Company)
Fremantle Media
ITV (Studios segment)
Kew Media Group UK Limited
Prosiebensat.1 (Content Production & Global Sales segment)
Branded services
AMC Networks
FIVE
ITV (Broadcast & Online segment)
Prosiebensat.1 (Broadcasting German-speaking segment)
RTL (excluding Fremantle Media)
STV Group plc (Consumer segment)
The E.W. Scripps Company
UKTV
Consumer products
Discovery (Education segment)
DVD.com
EA Sports Inc.
Entertainment One (Family & Brands segment)
Sega Sammy (Entertainment Contents segment)
Ubisoft Entertainment

¹⁰⁹ Where there is sufficient information provided in the comparator accounts, we have treated amortisation of programme titles as an operating expenses and allocated shares of group costs (in proportion with revenue), to align with Studios' accounting treatment.

The benchmarking results for the sets of companies comparable to Studios' lines of business are presented in Table 7 below.

Table 7: Studios EBITDA margin benchmarking results

Weighted average EBITDA margins (2014-2017)	Production and Content sales¹¹⁰	Branded services	Consumer products*
Maximum	11.6%	34.2%	60.8%
Upper quartile	10.7%	29.8%	46.1%
Median	9.6%	26.2%	27.5%
Lower quartile	8.1%	19.3%	13.3%
Minimum	4.5%	8.7%	7.7%
Number of observations	6	8	6

**We consider that the Consumer Products line of business is the most difficult for which to find organisations performing comparable activities to Studios. The level of comparability of this set of organisations to the BBC's commercial activities is likely to be lower than that of the other sets.*

6.4.4.2 Comparison to Studios' 2017/18 results

2017/18 actual EBITDA margin results are not available at the line of business level for Studios, as it did not exist in its current form for the full year. Therefore, we have only compared the benchmarked ranges to Studios' forecasts by line of business.

6.4.4.3 Comparison to Studios' forecasts

Within Studios, the Production and Content Sales, and Branded Services lines of business are projected to be within the benchmarked interquartile range by the end of the forecast period. The margin for Consumer Products is forecast to be just below the range, but we note the likely lower level of comparability of the organisations in this benchmark group.

We note that there are some uncertainties in relation to the forecasts, as discussed in Section 6.4.2.2. However, based on the benchmarking analysis, we consider Studios' lines of business to be earning a commercial return.

6.4.5 Findings

- ▶ **Strategic direction:** Studios has identified strategic priorities and regularly conducts activities that appear to be strategic in nature. Studios was formed in 2017/18 – the strategy for doing so has been well-documented, and reflects the issues noted in relation to the market context for Studios.
- ▶ **Budget planning and monitoring:** Studios has a detailed budget plan with forecasts. It reports financial information to the Board and Ofcom on an ongoing basis, and produces monthly financial reports. We therefore consider that it engages in sufficient and appropriate budget planning and monitoring.
- ▶ **Investment appraisal:** There are several cases of Worldwide – Studios' primary predecessor – undertaking significant investments that have been rigorously appraised. Where investments were not as successful as projected, in-depth analysis has been conducted to feed into and improve the appraisal of future investments.

¹¹⁰ The benchmarked quartiles for Production and Content Sales are the same, taken from a combined set of comparators for the two lines of business. We have not been able to separately benchmark Production or Content Sales, as many of the comparator organisations perform both functions.

- ▶ **Earning a commercial rate of return:**
 - ▶ All of Studios' lines of business are profitable. Furthermore, they are all forecast to earn EBITDA margins within – or on a trajectory towards – their applicable benchmarked margin ranges.
 - ▶ Therefore, notwithstanding some potential uncertainties around Studios' forecasts, we conclude that its lines of business earn a commercial rate of return.
 - ▶ We note that the Consumer Products line of business is particularly difficult to benchmark as a standalone activity.

6.5 Global News

6.5.1 Strategic direction

Global News prepared a strategy document in February 2018, outlining its business strategy and financial plan for the next four years. The document's introduction includes Global News' purpose, its three-year goals and objectives and market context. Performance metrics and targets are provided for each year until 2020/21. The strategy is broken down into editorial, digital, engineering and operations elements, and revenue streams (core and potential new ones). It also contains organisational development plans, and a financial plan with profitability targets and three key methods of driving profitability, before closing with a 12-month operational roadmap.

This in-depth strategy document contains measurable plans and metrics, allotted to specific time periods. It demonstrates that Global News looks to achieve a positive PBIT (and therefore to maintain profitability at the EBITDA level). Although these EBITDA and PBIT figures have been derived from the same financial plan, we note that there nevertheless remain differences between the measure used for business planning and that reported to Ofcom in the form of a measure of rate of return.

6.5.2 Budget planning and monitoring

6.5.2.1 Historical financial performance¹¹¹

- ▶ **Revenue:** Global News' revenue increased from £101.4m in 2015/16 to £108.7m in 2017/18, an increase of 7%.
- ▶ **Cash flow:** Global News' FCF increased from -£6.1m in 2015/16 to £0.7m in 2017/18¹¹². Its borrowing also remained below £56m during this period, well below the portion of the net commercial borrowing limit allocated to it of £72m¹¹³.
- ▶ **Profitability:** Global News' EBITDA increased from £0.7m in 2015/16¹¹⁴ to £2.2m in 2017/18¹¹⁵. Global News did not pay a dividend to the BBC Group during the period from 2015/16 to 2017/18.

6.5.2.2 Forecast financials

Global News' key forecasts are projected to be within the benchmarked range throughout the forecast period. These forecasts are underpinned by a set of revenue-enhancing strategy

¹¹¹ Historical financial performance metrics have been sourced from Commercial Holdings' financial statements unless otherwise stated.

¹¹² Provided by Global News

¹¹³ BBC, October 2018, *Actual Net Debt Commercial Holdings Group 3 Year Trend FY 2015/16 to H1 2018/19*

¹¹⁴ Provided by Global News

¹¹⁵ Exclusive of foreign exchange gains on the year-end valuation of hedged positions of £15.6m.

projects that we understand Global News is actively pursuing. For example, Global News launched BBC Reel, a new video features platform on BBC.com, in October 2018¹¹⁶.

However, there are risks to Global News' positive forecasts, and we consider these risks to be higher than those we have observed for the BBC's other commercial subsidiaries.

That said, we have reviewed the accuracy of Global News' forecast financials. Of the data points¹¹⁷ forecast for 2012/13, only 17% exceeded the actual result by more than 5%. Forecasts have been relatively conservative, with over half of forecasts below actuals by more than 5% since 2012/13. Our analysis suggests that Global News' forecast financials are generally conservative, and we therefore consider that the approach to forecasting is reasonable.

6.5.2.3 Financial performance monitoring

Global News reports annual forward-looking rate of return targets to Ofcom. Please refer to Section 8.5 for further details of this process for 2018/19.

Global News also prepares a range of other documentation to demonstrate the extent to which it undertakes business planning and monitoring, and to contribute to its operating in a commercially efficient manner:

- ▶ **Quarterly performance reviews:** Global News prepares quarterly performance reviews. These recap the strategy set out in the strategy document described above, review progress against this, and look ahead to the following quarter. They also review year-to-date financial performance and full-year outlooks and analyse industry developments (i.e. competitors) to closely internally monitor financial performance.
- ▶ **Commercial reporting packs:** Monthly commercial reporting packs are prepared for Global News, for review by the Commercial Holdings Board. These summarise year-to-date performance, market position, business development and change, and performance and people initiatives. They then analyse income and expenditure statement actuals, budgets and variances on both a year-to-date and full-year basis, before doing the same for FCF (and conversion) and net debt. The packs also include such analysis for the balance sheet, cash flow statement and staff costs on a quarterly basis only.
- ▶ **Monthly performance reports:** Global News also produces monthly summaries of performance in order to measure against its targets around quality, reach and value. This is done through assessing platform performance (digital and TV), sales performance (advertising and distribution), and financial performance.
- ▶ **Sales Policy:** Global News has a published Sales Policy document, the objective of which is to provide a framework for commercial products sold. The document details limits and guidance with respect to various areas, including discounts, premium ad placement, data, content sales, product placement, yield management and sales procedures.
- ▶ **Impairment review:** In 2018, Commercial Holdings carried out an impairment review of Global News. It found that its estimated equity value exceeded its carrying value, and therefore that no impairment was required. This is a further indication that the business is being operated in a commercially efficient manner.

6.5.3 Investment appraisal

We have reviewed the following case study to consider the BBC's governance and investment appraisal processes for Global News:

¹¹⁶ BBC [online]. Available at: <https://www.bbc.co.uk/mediacentre/worldnews/2018/reel>

¹¹⁷ The data points forecast include sales, EBITDA and net debt.

► **Case study: Expenditure & Deal Approval Process**

- Global News' Expenditure & Deal Approval Process document is effective from 1 April 2018. Its purpose is to set out the approval process for all Global News expenditure and revenue deals, and list the names of authorised signatories within Global News. The document specifies which individuals or bodies must approve expenditure and deals exceeding defined thresholds. The process to be followed on bad debt write-offs, consultancy spend and investment valuation are also described.
- All staff involved in the expenditure and deal approval process are aware of policy documents and know that they must follow the policy. There are various level of reviews with different levels of sign-off required before credit control can release any payments. Similarly, with deals, there are various levels of sign off depending on deal size. Adherence to the policy is subject to internal audit.

6.5.4 Earning a commercial rate of return

We have collated a group of comparator organisations to Global News. Global News' EBITDA margin can be compared to the benchmarking results to give an indication as to whether it is earning a commercial rate of return.

6.5.4.1 Comparator organisations and benchmarking results

The set of comparator organisations is listed in Table 8 below.

Table 8: List of comparator organisations for Global News

Buzzfeed UK Limited

Daily Mail and General Trust plc – Media

Deutsche Welle

Euronews NBC

Guardian Media Group

Independent News and Media PLC

ITN

The Associated Press

The New York Times Company

The full range of the benchmarking results, with the interquartile range highlighted, is presented in Table 12 below.

Table 9: Global News EBITDA margin benchmarking results

<i>Weighted average EBITDA margins (2014-2017)</i>	Global News
Maximum	17.9%
Upper quartile	10.8%
Median	7.0%
Lower quartile	-7.1%
Minimum	-20.5%
Number of observations	9

6.5.4.2 Comparison to Global News' 2017/18 results

Global News recorded an EBITDA margin of 2.0% in 2017/18, which lies within the benchmarked interquartile range, between the lower quartile and the median. Global News having a margin within the interquartile range, despite recording a modest margin, is indicative of the fact that the market for news is challenging. News providers are experimenting with a range of different business models, with varying degrees of success; some of Global News' peers are profitable, while others are lossmaking. There is no clear consensus on the best route to long-term stability and profitability.

6.5.4.3 Comparison to Global News' forecasts

Global News' EBITDA margin is forecast to be in the benchmarked interquartile range in each year until 2020/21. It is forecast to increase its profitability during this time.

As Global News' EBITDA margin was in the benchmarked range for 2017/18 and is forecast to continue to be so for the period to 2020/21, we consider it be earning a commercial return. This has been driven by Global News working to improve the efficiency of its business. However, we note that there is uncertainty surrounding the forecast ranges discussed in Section 6.5.2.1. Caution and care should be taken by the BBC to ensure that Global News is, and will continue to, earn a commercial rate of return. Global News is in the first year of its latest strategic plan to improve profitability. Continued close monitoring of performance, management flexibility and responsiveness to adverse performance will therefore be important.

6.5.5 Findings

- ▶ **Strategic direction:** Global News has prepared an in-depth strategy document analysing a number of areas (which reflects the issues noted in relation to the market context for Global News), and with a clear aim to improve profitability.
- ▶ **Budget planning and monitoring:** Global News has a detailed budget plan with forecasts. It reports financial information to the Board and Ofcom on an ongoing basis, and produces quarterly and monthly financial reports. It engages in sufficient budget planning and monitoring.
- ▶ **Investment appraisal:** Global News has a clear framework in place for the appraisal of investments, and there are various measures in place to ensure that it is adhered to.
- ▶ **Earning a commercial rate of return:** Global News' 2017/18 EBITDA margin is in the range of the EBITDA margins of comparator news providers, although we have observed a wide range of returns in our benchmarking assessment. Global News is also forecast to

remain within the benchmarked range of returns during the period 2018/19 to 2020/21. Therefore, notwithstanding uncertainties around Global News' forecasts, we conclude that its lines of business earn a commercial rate of return.

- ▶ However, the commercial outlook for Global News is finely balanced, given the challenging market in which it operates. News providers are responding to the market by experimenting with a range of different business models, with varying degrees of success, but there is as yet no consensus on the best route to long-term profitability. Global News has developed, and is implementing, a strategy that seeks to respond to the changing market environment. Execution of this strategy will be essential for Global News to secure sustainable profitability and to continue earning a commercial rate of return in the longer term.

6.6 Studioworks

6.6.1 Strategic direction

Studioworks prepares a board pack as part of its planning, which is conducted under the guidance of the BBC Board. The April 2018 edition of the pack includes the company's commercial and financial, operational, and people objectives. Each objective also has respective measures of success and associated activities. The document also includes a brief market overview conducted by Studioworks, highlighting market segmentation and challenges.

Studioworks' board pack includes objectives and tangible measures of achieving these. Further, our discussions with Studioworks indicate that the business takes into account the issues noted in relation to the market context for Studioworks. However, we have not seen a separate and clearly defined strategy document.

6.6.2 Budget planning and monitoring

6.6.2.1 Historical financial performance¹¹⁸

- ▶ **Revenue:** Studioworks' revenue increased from £24.8m in 2015/16 to £30.8m in 2017/18, an increase of 24%, due in part to the adoption of Television Centre into the portfolio for part of the year.
- ▶ **Cash flow:** Studioworks' free cash flow decreased between 2015/16 and 2017/18¹¹⁹. This was driven by Studioworks' high capex resulting from its large asset investment during this period in relation to the expansion into Television Centre (an effective doubling of the company's studio capacity).
- ▶ **Profitability:** Studioworks' EBITDA increased between 2015/16 and 2017/18¹²⁰. Studioworks did not pay a dividend to the BBC Group during the period from 2015/16 to 2017/18. However, as part of the closure of the Digital Media Service ("DMS") arm of the business, assets were transferred to the BBC in 2015/16. From 2018/19, it is anticipated that Studioworks will begin paying cash dividends.

6.6.2.2 Forecast financials

In November 2017, Studioworks prepared a three-year budget submission covering the period 2018/19 to 2020/21.

EBITDA is forecast to be relatively stable. However, Studioworks' future profitability remains heavily dependent on short term transactions, and (albeit to a decreasing extent) on BBC contracts. Downside risks to the forecasts therefore include revenue and cost uncertainties for

¹¹⁸ Historical financial performance metrics have been sourced from Commercial Holdings' financial statements unless otherwise stated.

¹¹⁹ Based on information provided by Studioworks

¹²⁰ Based on information provided by Studioworks

Television Centre, the risk of losing BBC contracts, and the speculative nature of revenue assumptions from 2019/20 onwards.

That said, we have reviewed the accuracy of Studioworks' forecast financials. Of the data points¹²¹ forecast for 2012/13, only 36% exceeded the actual result by more than 5%. Forecasts have been relatively conservative, with over half of forecasts below actuals by more than 5% since 2012/13. Our analysis suggests that Studioworks' forecast financials are generally conservative, and we therefore consider that the approach to forecasting is reasonable.

We note that a number of external factors have created challenges for the financial performance of Studioworks over recent years. These include the move of numerous BBC studio shows to Salford (including the BBC Sports and Children's genres), the closure of Television Centre in 2012 (leading to the business relocation to Elstree), the move of BBC News work to Broadcasting House, and the expansion into the redeveloped Television Centre. In each case, Studioworks has maintained or returned to profitability after a period of transition. The BBC has stated that Studioworks will begin paying cash dividends to the BBC from 2018/19.

6.6.2.3 Financial performance monitoring

Studioworks reports annual forward-looking rate of return targets to Ofcom. Please refer to Section 8.5 for further details of this process for 2018/19.

Quarterly commercial reporting packs are prepared for Studioworks, for review by the Commercial Holdings Board. These compare year-to-date performance to budget, as well as comparing full year forecasts to budget, for the income statement, balance sheet, FCF, net debt and staff costs.

In 2018, Commercial Holdings carried out an impairment review of Studioworks. It found that its estimated equity value exceeded its carrying value, and therefore that no impairment was required. This is a further indication that the business is being operated in a commercially efficient manner.

6.6.3 Investment appraisal

The vast majority of Studioworks' investments relate to technical/broadcast equipment purchases linked to revenue and return on investment objectives. These investments are not typically complex in nature nor material in nature and are therefore captured in straightforward business cases. We have therefore considered the following case study to demonstrate the BBC's governance and investment appraisal processes for Studioworks:

► Case study: Digital Media Services ("DMS")

- DMS was part of the Studioworks business before being closed in 2015/16 after becoming lossmaking. DMS represented a strong revenue stream with a high margin until 2011/12. A status update was prepared at the end of 2014/15, which examined revenue and contribution forecasts, medium-term breakeven turnover requirements, opportunities, market analysis, and cost-benefit analysis of various strategic options, including closure. These indicated a sharp decline in business including the loss of a major contract which moved DMS into a lossmaking position, and created an uncertain outlook on whether the DMS business could be returned to profitability over the medium term.
- As a case study, DMS demonstrates Studioworks' commercial efficiency. When it was profitable and continued to meet the other commercial criteria, Studioworks continued to operate it. When it ran into financial trouble, Studioworks assessed the scope to return the business to profitability and undertook measures to attempt to do so.

¹²¹ The data points forecast include sales, EBITDA and net debt.

6.6.4 Earning a commercial rate of return

We have collated a group of comparator organisations to Studioworks. Studioworks' EBITDA margin can be compared to the benchmarking results to give an indication as to whether it is earning a commercial rate of return.

6.6.4.1 Comparator organisations and benchmarking results

The set of comparator organisations is listed in Table 10 below.

Table 10: List of comparator organisations for Studioworks

Dock 10

LH2 Studios

Pinewood Group Limited

As the number of comparator organisations to Studioworks identified is smaller than six, we are unable to derive an interquartile range of weighted average EBITDA margins. The full range of results is 8.4% to 34.6%.

It should be noted that that Dock10 may be considered the most comparable company to Studioworks in terms of size and scope of business. Pinewood is a larger, international organisation focused on the higher margin film sector. LH2 Studios is a facility provider, but only hosts one significant TV production and procures revenues from several other sectors. It is also worth noting that some studio providers such as Pinewood own the freehold rights to their facilities, whereas Studioworks holds a lease over its facilities which increases its cost base through rental payments.

6.6.4.2 Comparison to Studioworks' 2017/18 results

Studioworks recorded an EBITDA margin of 10% in 2017/18, which is within the full range of observed EBITDA margins for the set of comparator organisations identified, albeit close to the minimum. This lower result in part reflects that Studioworks reopened its facilities in Television Centre following the redevelopment of the site. This required significant investment, resulting in Studioworks doubling the size of its business and creating the need to fill the newly developed site with customers. While the associated costs were incurred immediately, revenue will take longer to build up to a steady state level. In addition to being within the full range of margins, Studioworks' margin is in line with that of Dock10.

6.6.4.3 Comparison to Studioworks' forecasts

Studioworks' EBITDA margin is forecast to be within the range of margins for the comparator organisations identified. The forecast margin is in line with the margin achieved by Dock10, arguably Studioworks' closest comparator. Although we have noted that some risks remain around Studioworks' forecasts, the margin forecast is in accordance with the fact that there is likely to be consistent market demand for Studioworks' services in the future. Therefore, we conclude that Studioworks is earning a commercial rate of return.

6.6.5 Findings

- ▶ **Strategic direction:** Studioworks' budget pack includes objectives and tangible measures of achieving these. However, we have not seen a separate and clearly defined strategy document. We note that any such documentation should be proportionate to the size and complexity of the business. Further, our discussions with Studioworks indicate that the business takes into account the issues noted in relation to the market context for Studioworks.
- ▶ **Budget planning and monitoring:** Studioworks has a budget plan with forecasts. It reports financial information to the Board and Ofcom on an ongoing basis, and produces

quarterly and monthly financial reports. It engages in sufficient budget planning and monitoring.

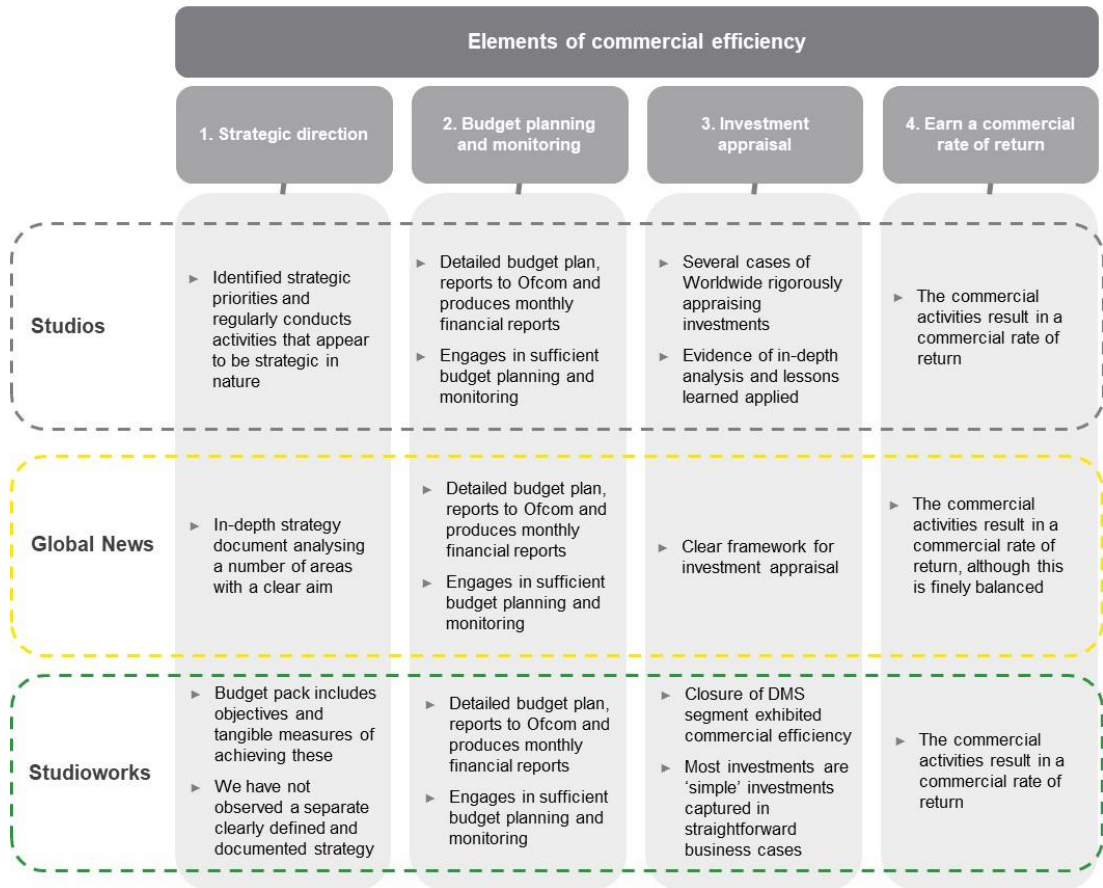
- ▶ **Investment appraisal:** Studioworks' closure of its lossmaking DMS segment indicates a commercial approach to investment appraisal.
- ▶ **Earning a commercial rate of return:** Studioworks' 2017/18 EBITDA margin was within the full range of margins of comparator organisations, close to the minimum observed. This lower result in part reflects that Studioworks reopened its facilities in Television Centre following the redevelopment of the site, a move which required significant investment. The scale of this expansion and the need to fill schedules with customers had a major operational impact on Studioworks.
 - ▶ Studioworks is profitable and is forecast to earn an EBITDA margin within the applicable benchmarked range during the period 2018/19 to 2020/21. Its current and forecast margins are in line with Dock10, arguably its closest comparator.
 - ▶ Although we have noted that some uncertainties remain around Studioworks' forecasts, the margin forecast is in accordance with the fact that there is likely to be consistent market demand for Studioworks' services in the future. Therefore, we conclude that Studioworks is earning a commercial rate of return.

6.7 Conclusions and recommendations

Based on our analysis, we consider that each of the BBC's commercial subsidiaries exhibits commercial efficiency. Each has in place a clear strategy and budget plan. We have reviewed case studies for investment appraisal and have seen appropriate processes in place to consider the commercial efficiency of investments. Further, these case studies indicate that lessons are learned and appropriate actions taken in respect of less successful investments to better inform future decision-making. We consider that each subsidiary is currently earning a commercial rate of return, as our benchmarking analysis indicates that returns are within, or projected towards, a market range – but we note that the market context going forward looks challenging for Global News. We further note that, to some extent for all of the main commercial subsidiaries, there are potential risks to the positive forecasts supporting our assessment.

Figure 5 summarises our findings for each main commercial subsidiary in respect of our definition of commercial efficiency.

Figure 5: Assessment of exhibition of commercial efficiency



In light of this, we recommend:

- ▶ The BBC considers whether there is scope for more systematic and regular review at the BBC Group level of historical, actual and projected performance. This information is especially relevant in the light of Ofcom's greater scrutiny of this area. Our interviews with BBC stakeholders also indicate that there may be scope for the main BBC Board to monitor the performance of the commercial subsidiaries more closely, in a manner proportionate to their business size and complexity.
- ▶ Given the challenging and uncertain market in which Global News operates, execution of its strategy – to secure sustainable profitability, and therefore ongoing commercial efficiency – should be a key area of focus for the BBC.
- ▶ The BBC should consider benchmarking a useful tool to provide an indicative range to assess the performance of its commercial subsidiaries, but should also consider other factors (such as the changing market context and the particular characteristics of its competitors) when assessing whether a business is earning a commercial rate of return. In this context, we note that the Consumer Products line of business for Studios is particularly difficult to benchmark as a standalone activity. The BBC should therefore consider the most appropriate method for benchmarking its activities going forward.

7. Not jeopardise the good reputation of the BBC or the value of its brand

7.1 Background

The BBC considers its brand to be its most valuable asset¹²². In measures of brand health, BBC services rank highly among UK brands: the BBC iPlayer ranks second, after John Lewis; while BBC One ranks ninth¹²³. Research suggests that audiences think that the BBC offers consistently high-quality output across its range of services, and value the BBC for playing an important role in British society¹²⁴. Generally, audiences' positive views of the BBC's reputation and brand are likely to be influenced by its role as a public service broadcaster, and its remit to inform, educate and entertain.

According to the Agreement, the third commercial criterion requires that the BBC's commercial activities "*must not jeopardise the good reputation of the BBC or the value of the BBC brand*". Given the BBC's business is primarily content creation and distribution, maintaining the BBC's editorial standards and values across its commercial services is the most important factor in ensuring that the BBC's reputation and brand are protected. However, the criterion is broader than editorial standards alone. The BBC's reputation and brand could be affected by a range of other factors, from the partners that the commercial subsidiaries choose to work with, to health and safety and information security issues¹²⁵.

7.2 Our approach

In assessing the BBC's commercial subsidiaries with the third criterion, we have considered:

- ▶ **The overall framework through which the BBC seeks to protect its reputation and brand value:** We have considered the specific guidelines and requirements that the BBC has in place relating to its reputation and brand.
- ▶ **The specific application of that framework to each of the commercial subsidiaries:** We have considered the practical application of the BBC's overall approach by each subsidiary, as well as any specific guidelines or requirements relating to each subsidiary.

Our review has been based on discussions with the Editorial Policy team, the Marketing & Audiences team, and the commercial subsidiaries. We have also reviewed documentation provided by these and other relevant teams within the BBC.

7.3 The BBC's approach to protecting its reputation and the value of its brand

7.3.1 Specific policies and guidelines

The BBC has an extensive range of policies and guidelines in place designed to safeguard its reputation and brand. The commercial subsidiaries must consider these policies and guidelines when seeking to ensure that their activities comply with the third commercial criterion.

¹²² BBC Branding, [online]. Available from: <https://www.bbc.co.uk/branding>

¹²³ YouGov, 2018, *BrandIndex: United Kingdom*, [online]. Available from: <http://www.brandindex.com/ranking/uk/2018-index/top-index-improver-rankings>

¹²⁴ Ipsos MORI, June 2017, *BBC Distinctiveness: Report prepared for Ofcom*, [online]. Available from: https://www.ofcom.org.uk/data/assets/pdf_file/0025/102958/bbc-distinctiveness-ipsos-mori.pdf

¹²⁵ We note that the BBC's approach to pay and reward could also affect its reputation and brand. We have not considered this as part of this review because we consider it to be an issue relevant to the BBC as a whole, rather than specifically to the commercial subsidiaries, and because the issue is addressed in the BBC Commercial Transparency Review (led by Christopher Saul).

At the core of these are the BBC's Editorial Guidelines, which reflect the editorial values and standards of the BBC. The Editorial Guidelines set out how content producers must deal with contentious editorial decisions, and how to ensure content meets audiences' expectations.

The Editorial Guidelines work by a system of referrals. This system sets out recommendations for when certain content should be referred to senior colleagues or the Editorial Policy team. Some of the referrals are mandatory. For example, "*Any proposal to rely on a single unnamed source making a serious allegation or to grant anonymity to a significant contributor must be referred to Director Editorial Policy and Standards and Programme Legal Advice*".

In the case of a breach of the Editorial Guidelines, complaints are managed centrally¹²⁶. The first point of contact for a complaint is BBC Audience Services. Complaints can be escalated to the BBC's Executive Complaints Unit. If complainants are not satisfied by the BBC's response, they may have a right of appeal to Ofcom.

In addition to the Editorial Guidelines, the commercial subsidiaries must comply with other BBC guidelines and requirements:

- ▶ **Advertising and Sponsorship Guidelines**, which set out the principles and standards for advertising and sponsorship on the BBC's commercial services. These guidelines specify that advertising must comply with the Advertising Standards Authority Code and must be clearly presented as commercial content, distinct from editorial. These guidelines explicitly consider the BBC's reputation and brand, by requiring that advertising meets consumer expectations of the BBC and does not bring the BBC into disrepute. There are also prohibited categories of advertising (including religious advertising, adult products and services, tobacco, weapons and guns clubs) to protect the BBC's reputation.
- ▶ **Guidelines for BBC Commercial Services on Editorial Integrity and Independence from External Interests**, which seek to ensure that the BBC is independent of arrangements that could "*undermine its editorial integrity, independence or impartiality*". The guidelines cover advertising, sponsorship and product placement, as well as prohibiting anyone working for the BBC or its commercial services from receiving personal benefits from suppliers.
- ▶ **BBC Branding Guidelines**, which are provided by the BBC's Central Branding team. More in-depth guidelines for commercial subsidiaries are produced on a case-by-case basis when the commercial subsidiary is established. These individual guidelines describe the rights that the commercial subsidiaries have to use the BBC brand, as well as how much the commercial subsidiaries pay the BBC to use its brand. The BBC must give written approval to some uses of the BBC "masterbrand", for example, for marketing.

The BBC also has a range of more general guidelines in place, with which the commercial subsidiaries are also required to comply. These include the BBC's health and safety, data protection, child protection and anti-bribery policies, and its general code of conduct.

Overall, these guidelines and requirements aim to protect the BBC's reputation and brand in a number of ways. They aim to ensure that content produced, broadcast and distributed by the commercial subsidiaries meets the high standards required of content produced by the BBC. They aim to ensure that audiences are clear about the distinction between the licence-fee funded UK Public Services and the BBC's commercial subsidiaries with regard to advertising and sponsorship. They also aim to protect the reputation of the BBC more widely, as a responsible business and employer. Taken together, we consider that these guidelines, if complied with, would sufficiently safeguard the BBC's reputation and brand. Below, we consider compliance with the guidelines.

¹²⁶ Except complaints under Ofcom's remit for Fairness and Privacy, which can be made to Ofcom in the first instance.

7.3.2 Compliance procedures and responsibilities

The commercial subsidiaries are individually responsible for compliance with the third commercial criterion. Consequently, there is no central team at BBC Group-level that has direct sign-off or approval over the links between the commercial subsidiaries' activities and the BBC's reputation and brand.

That said, central functions within the BBC support the commercial subsidiaries in this area – for instance, by being involved in any significant new venture or activity on an advisory basis. Editorial considerations are often relevant to ensuring that the third criterion is met, and as a result the Editorial Policy team is a key internal stakeholder. We understand that the Editorial Policy team works with the commercial subsidiaries in the following manner:

- ▶ Generally, the Editorial Policy team is available to give advice on how to work within the Editorial Guidelines at every stage of the production process, for any venture. The Editorial Guidelines encourage all output teams, including the commercial subsidiaries, to consult the Editorial Policy team for advice on how to interpret or apply the guidelines.
- ▶ Such advisory discussions are generally initiated by the relevant commercial subsidiary. For instance, we understand that the regulatory and standards teams within the subsidiaries often approach the Editorial Policy team to receive informal advice at an early stage of consideration of a new venture or activity.
- ▶ In particular, the Editorial Policy team plays an advisory role in significant new commercial activities. In so doing, the Editorial Policy team seeks to act impartially, in a manner independent from the subsidiary proposing and implementing the activity in question. As proposals develop, the Editorial Policy team gives formal advice to inform the refinement of the relevant propositions.
- ▶ In addition to the Editorial Policy team, the Marketing & Audiences team is available to advise the commercial subsidiaries on any issues that arise relating to brand usage and protection.

Given that the role of the Editorial Policy team is generally advisory, it is also important to note that a number of formal checks and balances exist to ensure that reputational and brand implications are properly taken into account in decision-making:

- ▶ The formal approval processes for commercial activities takes reputational and branding implications into account. This is notably the case when new (or material changes to) services require formal regulatory approval. For instance, editorial policy considerations were particularly important in the context of creation of Studios (as a commercial production business) in 2017, given that the new commercial production business would have the ability to produce content for third party (non-BBC) UK broadcasters. Further relevant examples include the 2014 transaction in which AMC Networks (a US-based cable network) acquired a 49.9% stake in BBC America. We discuss individual case studies in more detail in the sections below.
- ▶ Reputational and branding considerations are taken into account at a board-level by both the BBC Commercial Holdings Board, and the main BBC Board.
- ▶ Further, we understand that formal escalation and approval routes operate within the subsidiaries to ensure proper scrutiny of proposals from the perspectives of reputation and brand. We discuss each commercial subsidiary's compliance procedures below.

7.4 Studios

7.4.1 Application of the approach by Studios

The original proposal to establish Studios included measures for safeguarding the reputation of the BBC and the value of its brand. The risk of reputational damage was particularly relevant for Studios production because, for the first time, Studios would produce content for third party

(non-BBC) broadcasters and partners in the UK. Studios is required to comply with all of the BBC's guidelines and requirements, as outlined in Section 7.3. It is also required to appoint a compliance, editorial and governance ("CEG") manager with Production, who is responsible for ensuring compliance with BBC regulatory policy.

Following the merger, Studios established an Editorial Standards team comprising the Head of Editorial Standards and two Editorial Standards Managers. One of these Editorial Standards Managers focuses on Production and the other on Distribution. The Head of Editorial Standards is a senior editorial figure within Studios, reporting to the Director of Regulatory Affairs. This role reports into the BBC Group boards as required. The Editorial Standards Manager for Production is the CEG and plays a key role in ensuring compliance of productions.

Studios ensures compliance with editorial standards and values in the following ways:

- ▶ Responsibility for compliance with the BBC's editorial standards and values rests with Studios. However, as noted above, central functions play an advisory role to support Studios. For example, we understand that, when Studios is developing content ideas prior to commissioning, the development teams can request advice from the Editorial Policy team about whether the programme idea in question might raise any editorial concerns from a BBC reputational perspective.
- ▶ The Editorial Standards team provides advice and guidance on editorial standards issues jointly with the Editorial Policy team. The Editorial Standards team manages Studios' response to incidents and complaints, and briefs the Director of Regulatory Affairs, General Counsel and other senior colleagues, reporting into the Editorial Standards and Complaints Committee when necessary.
- ▶ The Editorial Standards team is responsible for managing Studios' response to incidents and complaints, as well as identifying complaints or trends that might pose significant risk to the BBC.
- ▶ If an idea developed by Studios Production results in a commission by a non-BBC broadcaster, then the formal role of the Editorial Policy team ceases, and the production team liaises with the compliance team of the commissioning broadcaster. Within Studios Production, the Editorial Standards Manager is the point of contact for queries about the compliance requirements of third party broadcasters. In order to ensure that reputational protection remains in place, Studios continues to have access to the Editorial Policy team where necessary to ensure that third party content meets the Editorial Guidelines. Given that Studios now produces content for third party broadcasters, the processes for maintaining editorial standards for third party productions are still evolving.
- ▶ To track, manage and escalate risks, the Editorial Standards team is responsible for a single Managed Editorial Risk List for all of Studios. The list names each project title, a synopsis of the project, the nature of the associated editorial risk, and the responsible producer and senior editorial figure. The list is reviewed by the Compliance and Risk Committee and the Editorial Standards Group. In recognition of the new risk of reputational damage stemming from Studios producing content for non-BBC commissioners, the list initially includes all third party projects commissioned from Studios. There is also a pan-BBC Managed Risk Programme List, managed by the Editorial Policy team, which includes Studios commissions for the BBC where these are deemed to carry significant editorial risk.
- ▶ Special care is taken for third-party branded content produced, for example, for advertising, trusts and foundations, and media agency deals – given the risk of conflicts of interest arising and potential damage to the BBC's editorial integrity and reputation. Studios carries out reputational due diligence on partners, with this diligence considered as part of the approval process. Novel or contentious commissions must be referred to the Editorial Standards team and to the Production Committee. There are also excluded areas of business (such as pornography, political parties, lobbying groups, and tobacco, guns, and weapons manufacturers). Studios ensures that branded content does not

borrow or mirror BBC formats, brand, style, or feature talent synonymous with the BBC brand. All branded content must comply with the Editorial Guidelines, the BBC Branding Guidelines, and all relevant BBC Group guidance, policies and external regulations. Branded content is also limited to not exceeding 3% of Studios' annual turnover. We understand that Studios has declined to carry out business with certain partners or customers, due to reputational concerns. We recognise that the processes for safeguarding the BBC's reputation in relation to branded content are still evolving.

- ▶ Studios also has a governance process for BBC branded magazines and their associated websites. This process consists of a system of Editorial Review Boards (ERBs), which monitor the performance of the brands measured against a Statement of Editorial Purpose, Values and Criteria for BBC magazine brands, their websites and associated digital activity. The ERBs comprise BBC staff from associated programme areas and independent external experts. They feed into a Studios report, which also analyses reader panel data. The Annual Review Panel for BBC Magazine brands, consisting of independent external experts and senior BBC staff, including Editorial Policy, considers the report and makes its recommendations for improvement.
- ▶ BBC Worldwide produced an Editorial Framework Guide, which sets out the editorial framework for Worldwide employees in detail, bringing together all of the BBC's relevant policies and guidelines. We understand that this document is currently being updated following the merger to incorporate the operations of Studios Production.
- ▶ All new permanent and freelance employees in Studios Distribution are required to complete online training covering editorial standards and values. Colleagues in relevant roles are required to complete further training in an advertising and sponsorship standards modules and an editorial standards workshop called 'Safeguarding the BBC Values'. In Studios Production, colleagues in relevant roles are required to attend an equivalent editorial standards workshop.

Studios ensures compliance with more general BBC policies and guidelines in the following ways:

- ▶ Studios has a Compliance and Risk Committee, a sub-committee of the Studios Executive Committee, responsible for overseeing the implementation of the company's Risk Management Programme, Ethics and Compliance Programme, and Internal Audit arrangements. An Ethics and Compliance report is reviewed at the Compliance and Risk Committee on a quarterly basis, and is submitted to the Studios Executive Committee for noting. This ensures compliance with areas ranging from antifraud and corruption to health and safety, child protection and information security.
- ▶ Mandatory training is in place for relevant new permanent and freelance employees, relating to various aspects of ethics and compliance. This training covers the four commercial criteria, safety at work, privacy and information security.

7.4.2 Case studies

Below we set out relevant case studies, which provide examples of when Studios has acted, in line with its guidelines, in a way intended to safeguard the BBC's reputation and brand. These include two significant occasions where EY has identified that the BBC's reputation and brand was potentially at risk, due to the sale of BBC assets to a third-party (BBC Good Food and BBC America). Studios also provided information regarding an occasion where it rejected a potential corporate sponsorship deal because of risks to the BBC's reputation and brand; we have also assessed this to understand whether Studios complied with the policies and processes it has in place to comply with the third commercial criterion.

- ▶ **Purchase of BBC Good Food by Immediate Media:** Immediate Media purchased certain assets of the Good Food business from Studios in September 2018. As part of the acquisition, Studios licensed the BBC Good Food brand name and website domain to

Immediate Media. The agreement specifically considered how to safeguard the BBC's reputation and brand.

- ▶ **BBC America:** Worldwide sold a stake in BBC America to AMC Networks in 2014. Again, protecting the BBC's reputation and brand was a major focus of the agreement.
- ▶ **Corporate sponsorship:** Studios provided confidential information to us suggesting that it rejected a sponsorship opportunity with a corporate partner after an internal risk assessment raised concerns that the partnership could risk damaging the BBC's reputation and brand. Studios also provided us information regarding a sponsorship deal that was approved after spot checks did not identify any issues of non-compliance, and after sign-off by the Director of Editorial Policy and Standards.

7.4.3 Findings

- ▶ Studios provided us with significant information regarding how it complies with the third commercial criterion. Based on this documentation, and through interviews with Studios' personnel, we conclude that Studios considers how best to protect the BBC's reputation and brand when engaging in commercial activities, and has appropriate measures and procedures in place to ensure compliance.
- ▶ As noted above, we recognise that the process for maintaining editorial standards for third-party productions, including third-party branded content, is still evolving since the merger between Worldwide and legacy Studios. The BBC is progressing work in this area, which will require further monitoring and review. We therefore expect this to continue to be a priority area for Studios when considering how best to protect the BBC's reputation and brand.

7.5 Global News

7.5.1 Application of the approach by Global News

Global News complies with the BBC's Group-wide Editorial Guidelines. BBC News produces, and therefore has editorial oversight over, most of Global News's output, providing an additional safeguard. Global News also complies with the Advertising and Sponsorship Guidelines, and the conditions of use of the BBC brand contained in the brand licence agreed between Global News and the BBC, which cover, for example, how Global News can use the BBC brand for marketing purposes and events. Global News complies with the above guidelines in the following ways:

- ▶ A Head of Editorial Content is appointed to oversee compliance with the Editorial Guidelines. Any risky editorial decisions are discussed by the Head of Editorial Content, the Legal team and the Editorial Policy team to ensure content complies with the Editorial Guidelines. We understand that Global News interacts frequently with the Editorial Policy team.
- ▶ In the case of a breach of the Editorial Guidelines, complaints relating to TV output are forwarded to the relevant programme team. For complaints relating to online output, the complaint is sent to the relevant editor and the Head of Editorial Content.
- ▶ Appendix 6 of the Editorial Guidelines provides guidelines for the BBC World Service Group on External Relationships and Funding, which Global News is required to comply with. These guidelines cover the external relationships that the BBC World Service Group may have, which include sponsorship, external funding and co-productions. These guidelines seek to ensure that the BBC's impartiality, editorial integrity and independence are not compromised by any external relationship, and that external relationships do not result in any conflicts of interest. Global News outlines the process for compliance with the guidelines on external relationships and funding through a flowchart. The flowchart, which is shared among staff within Global News, sets out each stage of the compliance process when an external relationship is proposed, along with the person with the authority to sign off at each stage and any mandatory referrals.

- ▶ Global News has appointed an Advertising Standards Guardian to ensure compliance with the BBC's Advertising and Sponsorship Guidelines. The Advertising Standards Guardian assesses any adverts raising potential issues or which are subject to mandatory referrals, and reviews all proposed sponsorship. In some cases, the Advertising Standards Guardian refers the advert to an appointed senior editorial figure for review. Global News provided us with an example of a time it rejected an advertising partnership, which we discuss as a case study in Section 7.5.2.
- ▶ Global News also has a committee in place to approve new advertising formats and types of online sponsorship, namely the Advertising Governance Committee. The committee is made up of representatives from the editorial, legal and business affairs, digital product, advertising sales, and advertising operations teams from Global News, as well as a representative from the Editorial Policy team.
- ▶ Global News is required to comply with guidance developed by the Editorial Policy team on the use of the BBC brand for marketing events. This guidance sets out acceptable partners for trade marketing events, which covers events and conferences. For example, Global News will not participate in a conference organised by a single government, or which does not have a balanced range of topics, and all proposed conference participation activities are reviewed by Global News' Head of Editorial Content. Global News told us that it is selective about which commercial parties it works with so as not to jeopardise the BBC's reputation and brand, which we discuss further as a case study in Section 7.5.2.
- ▶ Basic Editorial Standards training is completed by all staff at the time of joining. Key editorial decision makers are required to also undertake Editorial Standards (face-to-face) training, a more advanced, case study-based classroom course.

In relation to other aspects of the BBC's regulatory, ethics and compliance framework:

- ▶ We understand that, as of November 2018, Global News updates the Commercial Holdings Board on a quarterly basis on ethics and compliance. Global News told us that it is following the Studios' model of tracking compliance across its locations and lines and businesses. Global News's Ethics and Compliance report is based on Studios' report and, as with Studios, ensures compliance with areas ranging from antifraud and corruption to health and safety, child protection and information security.

7.5.2 Case studies

Studios tends to have the largest ventures of the commercial subsidiaries, and the case studies it has in place are therefore more widely documented than those of the other two commercial subsidiaries. However, Global News provided us with confidential examples of times it acted to protect the BBC's reputation and brand:

- ▶ **Editorial considerations:** Global News provided us with email correspondence demonstrating how editorial decisions are taken. This email correspondence indicates that the Legal and Editorial Policy teams are consulted, and their advice taken into consideration, in decisions relating to potentially controversial or sensitive content. Issues that might arise as a result of the fact that Global News' activities are international also seem to be taken into account.
- ▶ **Advertising partnership:** Global News rejected an advertising deal in 2018 on the basis that it was political advertising. Global News provided us with emails from within Global News' commercial team, discussing the advertising partnership. These emails explicitly referred to the potential risk to perceptions of the impartiality and independence of the BBC's reporting and coverage, demonstrating that reputation and brand was a key consideration.
- ▶ **Conferences:** Global News provided us with an example of a conference that it did not participate in, because the conference was deemed to be organised and funded by a single government.

7.5.3 Findings

- ▶ Based on the documents that we assessed as part of our review, we conclude that Global News is committed to protecting the BBC's reputation and brand in editorial policy decisions, commercial relationships (including advertising) and general compliance issues like health and safety, data protection and bribery.

7.6 Studioworks

7.6.1 Application of the approach by Studioworks

Studioworks told us that it considers itself a facilities provider and does not seek to exploit the BBC brand in the same way as Studios and Global News. Studioworks believes its branding de-emphasises the BBC logo, and that these factors together partially lower the risk of its operations to the BBC's reputation and brand from an editorial perspective. We agree that Studioworks' customers would tend to seek out Studioworks' services for the facilities and technology that Studioworks offers rather than for the BBC brand. However, the BBC brand and name appears in Studioworks' logo, domain name and contact address; and Studioworks' website makes it clear that Studioworks is a commercial subsidiary of the BBC. As such, we consider that Studioworks could still affect the BBC's reputation and brand.

While editorial considerations are less of a factor for Studioworks than Studios or Global News, it still has to manage other risks to the BBC's reputation and brand in a similar way to the other commercial subsidiaries. These risks stem from the clients and suppliers that Studioworks chooses to work with, as well as more general issues like health and safety considerations and its data protection policies.

We understand that Studioworks has compliance procedures and guidelines in place to ensure that customers (and/or other commercial partners) of Studioworks are appropriate – for instance, to ensure that Studioworks avoids situations in which its facilities may be used to produce content that does not comply with Ofcom's Broadcasting Code. We understand that Studioworks carries out due diligence on potential customers in the following ways:

- ▶ Up until 2013, Studioworks produced monthly "Craft Forms" for submission to the BBC Fair Trading team and Editorial Policy team (as appropriate) so that they could monitor the volume and nature of Studioworks' revenues from non-BBC clients. These forms included questions around the suitability of clients and fit with the BBC's public purposes. The Craft Forms were discontinued by the BBC – we understand that this was because the forms were viewed as an unnecessary administrative exercise, given the rarity of occasions when Studioworks' transactions raised any concerns. The Craft Form regime was replaced by a reporting 'by exception' approach – we understand that this is rarely required because most of Studioworks' customers are Ofcom-licensed broadcasters or major production companies.
- ▶ The Editorial Policy team has developed guidelines for Studioworks, where approval is required from the Editorial Policy team if Studioworks wishes to engage in an activity involving a third party that could potentially undermine the BBC's editorial integrity – for example political parties, religious groups and lobbying organisations.

In relation to other aspects of the BBC's regulatory, ethics and compliance framework:

- ▶ Studioworks has a detailed health and safety policy in place, which sets out the health and safety responsibilities for staff and freelancers at Studioworks in different levels of seniority. We understand that Studioworks maintains a database of several hundred risk assessments and method statements to govern its activities, which list potential hazards and the controls in place to mitigate them. These risk assessments are uploaded to a website where staff and freelancers can easily access them.
- ▶ Studioworks is part of the BBC's data protection regime. Studioworks staff must complete mandatory BBC training on data protection, and Studioworks has scheduled meetings with the BBC's Information Security team and is subject to that team's oversight. We have seen

emails demonstrating that BBC Group-wide emails setting out guidelines for how to handle data are supplemented by local emails within Studioworks. Additionally, the standard terms of trade that Studioworks uses for client contracts specifically covers data protection, with provisions in place to ensure clients comply with data protection legislation and the BBC's data protection policies.

7.6.1 Case studies

As noted above, we understand it is rare for Studioworks to work with a customer who is not an Ofcom-licensed broadcaster or major production company, and therefore we have not been able to assess any occasions in recent years where Studioworks had to consider reputation and brand when contracting with a new customer. We understand that the most recent significant brand-related case affecting Studioworks was when the company rebranded from BBC Studios and Post Production in 2016. On this occasion, Studioworks consulted with the central BBC Marketing and Audiences team on the proposed branding as well as seeking approval to proceed up to BBC Director General level.

7.6.2 Findings

- ▶ Studioworks has stated that it sees itself as presenting a lower risk to the BBC's reputation and brand from an editorial perspective than the other commercial subsidiaries because it does not seek to exploit the BBC brand to win customers and it minimises the BBC name in its logo. However, we consider that Studioworks still has the potential to present a risk in other ways – for instance, as a result of the clients and suppliers that it chooses to work with, as well as more general issues like health and safety considerations and its data protection policies.
- ▶ From our interviews with relevant BBC personnel and review of the documents that Studioworks provided, we conclude that Studioworks has processes in place to protect the BBC's reputation and brand.

7.7 Conclusions and recommendations

Based on the findings above for each commercial subsidiary, we conclude that the commercial subsidiaries are committed to safeguarding the BBC's reputation and brand. We have not identified any specific occasions, practices or partnerships that risk causing damage to the BBC's reputation and brand.

However, we note that each of the subsidiaries ensures compliance with the third commercial criterion in different ways, and there may be more scope for knowledge sharing and consistency, to the extent appropriate, between the subsidiaries. For example, Global News told us that it is following Studios' approach to ensuring compliance with the BBC's general ethics and compliance framework. There may be other such areas where consistency of approach across the subsidiaries is beneficial.

In light of this, we recommend that the BBC carries out an internal study to understand how similar issues relating to reputation and brand are dealt with by different subsidiaries, to understand whether there is more scope for knowledge sharing.

8. Not distort the market or create an unfair competitive advantage

8.1 Background

There are flows of capital, assets and information between the BBC and its commercial subsidiaries, which could provide the BBC's commercial subsidiaries with an unfair competitive advantage. The fourth commercial criterion requires that the BBC's commercial activities *"must not, as a result of the relationship of the activity with the UK Public Services, non-service activities or trading activities, distort the market or gain an unfair competitive advantage"*¹²⁷.

Ofcom – as the BBC's external regulator – is required by the Agreement to define a regulatory framework that ensures that the relationship between the BBC's commercial activities and the UK Public Services, non-service activities or trading activities does not distort the market or create an unfair competitive advantage¹²⁸. The Agreement states that the trading and separation rules may include requirements to ensure appropriate separation between the BBC and its commercial subsidiaries, and to ensure appropriate transparency as to the relationship between the BBC and its commercial subsidiaries.

Ofcom places trading and separation rules on the BBC, which include requirements that:

- ▶ *"Relationships between the BBC Public Service and the commercial subsidiaries operate at arm's length;*
- ▶ *Commercial activities are carried out in accordance with normal market principles, including making a commercial rate of return; and*
- ▶ *The relationship between the BBC Public Service and the commercial subsidiaries is appropriately transparent, including providing Ofcom with financial reports and the publication of information"*¹²⁹.

8.2 Our approach

The Agreement provides Ofcom with the discretion to define the regulatory framework in a manner that Ofcom considers *"appropriate to secure the effective regulation of the activities of the BBC as set out in the Charter and this Agreement"*¹³⁰. Ofcom's operating framework – which includes requirements and guidance to put the fourth commercial criterion into effect, so as to ensure that the BBC's commercial activities do not distort or inhibit competition in the UK media market¹³¹ – comprises the following key elements¹³²:

- ▶ Operational separation;
- ▶ Supply and pricing of goods and services;
- ▶ Commercial rate of return; and

¹²⁷ BBC Agreement, Section 23 (5)

¹²⁸ BBC Agreement, Section 28 (1)

¹²⁹ Ofcom, July 2018, *The BBC's commercial and trading activities, Requirements and guidance: A consultation on proposed modifications to Ofcom's requirements and guidance*, pg. 3, paragraph 1.12

¹³⁰ BBC Agreement, Section 5 (1)

¹³¹ This framework was put in place in July 2017. In July 2018, Ofcom issued a consultation on changes to the operating framework with regards to the BBC's commercial and trading activities. This consultation proposes changes to the 2017 requirements, based on Ofcom's subsequent experience and analysis of how the initial framework has worked in practice. The consultation concluded in September 2018 and Ofcom intends to publish a statement by the end of 2018.

¹³² In its description of the regulatory framework, Ofcom also lists "monitoring, reporting and transparency" as a separate category. However, as those requirements relate to monitoring and reporting of the other elements of the framework, we do not consider this as a separate category.

- ▶ Material changes to commercial activities.

For the remainder of this section, Sections 8.3 to 8.6 inclusive consider each of the above elements in turn and describe the requirements to which the BBC must adhere. We also consider how the BBC complies with the framework based on its policies, processes and governance arrangements.

Following our review of the above elements, Section 8.7 considers the broader external scrutiny from third parties in relation to the BBC's compliance with the regulatory framework; and Section 8.8 sets out our findings and recommendations in relation to the fourth commercial criterion.

To conduct this review, we performed a desk-based study to review information relating to the regulatory framework, including Ofcom and external documentation. We also conducted interviews with BBC teams to understand the detail behind published policies and to gain additional evidence to enable us to carry out our review. For the avoidance of doubt, we do not consider whether the BBC's commercial activities comply with competition law.

The BBC is allowed to carry out activities, which are commercial in nature, through other group functions outside of the commercial subsidiaries. These are defined as "trading activities", and are separate to the commercial activities that can only be carried out by the commercial subsidiaries. The Agreement defines the trading activities¹³³, which include the selling of assets or excess capacity in the BBC's resources held for use by the UK Public Services, and the provision of facilities and support services which are ancillary to the provision of the UK Public Services. Our review primarily relates to commercial activities, and only considers trading activities where they relate to the supply and pricing of goods and services to the commercial subsidiaries.

8.3 Operational separation

8.3.1 Ofcom requirements

The Ofcom operating framework states that *"the BBC must not directly undertake any commercial activities. All commercial activities must be undertaken through commercial subsidiaries"*¹³⁴. This has direct implications for the way the BBC is structured internally.

Ofcom highlights the need to ensure the commercial subsidiaries are independent of the BBC's UK Public Services, trading activities and non-service activities– for example, such that they can set their own objectives and strategy, and make decisions. Ofcom considers that the boards and executive committees of subsidiaries must be distinct and separate from the BBC Board and its committees. However, Ofcom notes that there are situations where it would be beneficial for a BBC Board member to also sit on a commercial subsidiary board. In these situations, the BBC must ensure there are appropriate safeguards and procedures to prevent conflicts of interest.

The regulatory framework also places restrictions on the exchange of information – such as *"restrictions on information regarding the BBC Public Service's strategy, priorities and activities that is not available to third parties which can be accessed by the commercial subsidiaries, and mechanisms to ensure that privileged information is only used for the specific purposes for which it was obtained"*¹³⁵. Ofcom recognises that some exchange of information between Group subsidiaries and the BBC's UK Public Services, trading activities and non-service activities will be necessary, for example when fulfilling contractual agreements. If a subsidiary has access to confidential commercial information that is not available to the market, the BBC must justify why the arrangement exists, and why the information is not available to the wider

¹³³ BBC Agreement, Section 31 (2)

¹³⁴ Ofcom, July 2017, *The BBC's commercial and trading activities, Requirements and guidance*

¹³⁵ Ofcom, July 2018, *The BBC's commercial and trading activities, Requirements and guidance: A consultation on proposed modifications to Ofcom's requirements and guidance*, pg. 13, paragraph 2.11

market. It must also put in place mechanisms that ensure the information is only used for the specific purpose it was intended for.

In July 2018, Ofcom issued a consultation on changes to the operating framework with regards to the BBC's commercial and trading activities¹³⁶. In this consultation, Ofcom proposes to maintain the 2017 requirements set out above, with only minor clarifications and changes. It is, however, proposing that an Annual Statement on Operational Separation should be published by the BBC. Ofcom suggests that this would give confidence to third parties and stakeholders that an appropriate internal framework for separation has been developed, and that the BBC is complying with the regulations.

In its response to Ofcom's consultation, the BBC has strongly questioned the need for this annual statement, especially given the BBC's commitment to publish more information about the governance of its commercial subsidiaries (an issue covered in Section 8.3.4).

8.3.2 BBC policies

The BBC legally separates the BBC from its commercial activities by conducting all commercial activities through subsidiaries. These subsidiaries are registered as separate companies and have their own articles of association submitted at Companies House. The BBC has 106 subsidiaries, including the four main subsidiaries that we cover within this review. Of the 106, the majority relate to Studios and its overseas operations. There are also 26 subsidiaries relating to Global News and 15 joint ventures and associates.

The NAO, in its landscape report on the BBC's commercial activities, concluded that the number of BBC commercial subsidiaries is in line with other international media companies in the UK – for instance, in 2016/17 ITV owned 437 companies and Endemol Shine Group owned 120¹³⁷.

8.3.3 BBC processes

The BBC has a set of internal processes and controls which seek to ensure that there is appropriate operational separation between the BBC and its commercial activities. As part of our review, we have covered the key processes regarding the creation of separate subsidiaries, commissioning guidelines, and controls on the flow of information between the BBC and its commercial subsidiaries.

8.3.3.1 Separate subsidiaries

Each commercial subsidiary is run as a distinct business, separate from the BBC's UK Public Services, trading activities and non-service activities. They each have their own internal processes, policies and procedures. In order to ensure separation, they also have their own management and executive teams, and are overseen by the Commercial Holdings Board. The main subsidiaries have processes to review the creation of any new subsidiary within the group structure.

In its July 2018 consultation, Ofcom stated that its "*primary competition concern*" for regulation of operational separation is "*to ensure that the relationship between the Public Service and the commercial subsidiaries is at arm's length*"¹³⁸. The BBC considers that the requirement for arm's length separation applies more appropriately to financial separation, rather than operational separation and overall governance of the BBC. The BBC set out its rationale for this view in its response to Ofcom's consultation¹³⁹:

¹³⁶ Ofcom, July 2018, *The BBC's commercial and trading activities, Requirements and guidance: A consultation on proposed modifications to Ofcom's requirements and guidance*

¹³⁷ National Audit Office, 7 March 2018 *BBC Commercial activities landscape report*, pg.17, paragraph 1.9

¹³⁸ Ofcom, July 2018, *The BBC's commercial and trading activities, Requirements and guidance: A consultation on proposed modifications to Ofcom's requirements and guidance*, pg. 13, paragraph 2.12

¹³⁹ BBC response to Ofcom consultation on changes to trading and separation rules, [online]. Available at: https://www.ofcom.org.uk/data/assets/pdf_file/0015/122505/BBC.pdf

- ▶ The BBC noted that the Charter states that the BBC Board has a duty to set “a *strategy and governance arrangements for the BBC’s commercial activities*”. The BBC stated that this establishes the primacy of the main BBC Board over the governance of the BBC’s commercial arm, and noted that “*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*”. The BBC noted the Charter obligations on the BBC Board to secure the effective and efficient management of the commercial subsidiaries, which the BBC Board exercises through the Commercial Holdings Board, and stated that it therefore did not consider it appropriate for the Commercial Holdings Board to operate at arm’s length from the BBC.
- ▶ The BBC also queried Ofcom’s use of “BBC Public Service” to mean the BBC legal entity (or BBC Group as a whole). The BBC noted that the remit of BBC Board and BBC directors, including the Director General, covers all of the BBC’s activities, both commercial and public service, and stated that operational separation should not inappropriately constrain the BBC Board and directors from exercising their duties of oversight over the BBC’s commercial activities, as well as the public service.

We understand that the BBC’s approach to operational separation reflects its understanding of the Charter obligations in relation to the role of the BBC Board and directors – notably that the Board’s responsibilities cover both public service and commercial activities. We understand that Ofcom intends to publish a statement following its consultation by the end of 2018.

8.3.3.2 Commissioning guidelines

In relation to operational separation, particular issues arise for Studios, given the need to ensure that the BBC’s commissioning of content occurs in a contestable environment – in which Studios competes with external (non-BBC) producers. The BBC has established commissioning guidelines which set out the principles and processes for ensuring new programmes and series are commissioned on fair, reasonable, non-discriminatory and transparent terms. In this review we have referred to the commissioning guidelines in order to assess the process for ensuring Studios is not given unfair advantage over competitors when new programmes are commissioned by the BBC.

In September 2017, the BBC published its current Commissioning Process Framework¹⁴⁰. The framework states that the BBC is committed to an open and transparent commissioning process. The BBC is also committed to implementing full competition for its television programming. It must meet its statutory independent production quotas but remove all historical in-house guarantees.

The BBC is required to open up the entirety of its commissioning to competition by the end of the current Charter period in 2027, with an interim target to be met by the end of 2018. As the BBC has committed to the targets over the coming years, it must ensure that any competitive tendering process is fair and open:

“The BBC Board will ensure that there is clear separation between the BBC’s commissioning teams and BBC Studios and in-house production functions to ensure that there is no conflict of interest or undue advantage to BBC Studios or in-house production in decision making. In particular, that there is clear operational and financial separation between the BBC Public Service (including its commissioning teams) and BBC Studios as of the launch of BBC Studios as a commercial operation”¹⁴¹.

The BBC also goes on to list the principles for competitive tendering in the framework:

- ▶ The process for the tender is clear, fair and transparent;

¹⁴⁰ BBC, [online]. Available from: <http://downloads.bbc.co.uk/commissioning/site/bbc-commissioning-process-framework.pdf>

¹⁴¹ BBC, September 2017, *Commissioning Process Framework*, pg. 4, paragraph 5.5

- ▶ The BBC's expectations regarding the requirements and eligibility of the applicants will be clearly stated in precise and consistent language in the Invitation to Tender documentation;
- ▶ It has established a clear set of criteria that will govern the decision to award a contract following that tender to a given party, which will include both creative and value for money considerations;
- ▶ The terms on which the contract to produce the tendered programme will be awarded will be clearly stated in the Invitation to Tender documentation;
- ▶ The contract will be awarded to the supplier whose tender has been determined as best satisfying the award criteria and fulfilling the BBC's overall requirements as stated in the Invitation to Tender paperwork; and
- ▶ The decision-making process (including criteria and timings) will be clear, transparent and adhered to at all times¹⁴².

The BBC stated that it will provide suppliers with access to business information and commissioning staff fairly, based on their status as a supplier and not based on their position relative to the BBC. All suppliers will be granted with equal resources and in-house production or Studios will not receive an unfair advantage.

Furthermore, the BBC will review any complaints regarding unfair competition and the separation of Studios and its relationship with the UK Public Services, trading activities and non-service activities through the Fair Trading complaints process. The BBC Board is also responsible for creating a Commissioning Compliance role to monitor whether there is a level playing field in commissioning, and also provide a point of appeal for complaints outside of BBC commissioning. The BBC will also regularly review its competition and separation arrangements in line with its Corporate Governance guidelines.

8.3.3.3 Flow of information controls

The BBC has a set of internal controls in place to restrict the flow of information between the BBC and its commercial subsidiaries. The BBC has six key internal controls to reduce the risk of unfair information sharing, as outlined below:

- ▶ **Conflict of interest procedures:** The BBC has established conflict of interest procedures for the BBC Board, Executive Committee and other decision-making bodies, as well as for staff generally. These procedures outline the processes for notifying any conflicts of interests for Board members, as well as transparency guidelines to ensure that they are well-documented and made available on the BBC's website.
- ▶ **Written guidance on information sharing for BBC Board:** We understand that the BBC is in the process of drafting guidance relating to information sharing. The purpose of this guidance will be to ensure that the members of the BBC Board and its sub-committees are aware of Ofcom's trading and separation rules. It will also outline how the BBC understands and interprets these rules. As this guidance had not been finalised during our fieldwork, we have not reviewed this guidance.
- ▶ **Non-disclosure agreements:** The BBC has procedures in place to ensure that non-disclosure agreements are signed and used where the BBC shares services with commercial subsidiaries, in specific circumstances where BBC staff are working with commercial subsidiaries and have access to commercially sensitive information. An example of this is when commercial rights staff employed by Studios also work with the BBC under a service level agreement. These staff are required to sign a non-disclosure agreement to ensure that Studios does not benefit from making use of any confidential information that these staff may have access to.

¹⁴² BBC, September 2017, *Commissioning Process Framework*, pg. 5, paragraph 6.2

- ▶ **Separation of access to relevant BBC systems by commercial subsidiaries:** The audience portal has restrictions which ensure that Studios does not have access to information that would not be available to third party production companies. The portal requires each user to sign in with their email address to be able to access audience information. Each user's profile dictates what information they will be able to access and view. As such, Studios employees only see data on the individual BBC programmes that Studios is producing.
- ▶ **Fair trading regulatory training for BBC staff in management roles:** The BBC has implemented two training courses that are designed to raise awareness of relevant regulatory issues. The first is an online course covering core concepts, terminology, guidelines and procedures. The course is mandatory for all Senior Managers, and anyone making day-to-day decisions around commercial activities, dealing with third parties and assessing the BBC's market impact. The second training course is a facilitator-led course (with facilitators drawn from the Regulatory and Economics team), which is interactive and covers a wide range of scenarios that are tailored to the attendees. It is mandatory for those who are directly involved in negotiating and approving commercial or trading activities. Those who require training are identified by a division's fair trading representative.
- ▶ **Fair trading advice provided by Regulation, economics and legal teams:** The Regulation and Economics team provides fair trading advice via a dedicated internal mailbox. Any BBC member of staff with a query about regulatory issues is able to seek advice from the team. Substantive queries are logged and recorded to ensure there is an audit trail and consistency in advice provided. The Competition and Regulatory legal team also provides advice when required. The BBC also has dedicated points of contact called "Fair Trading representatives" who are embedded in all BBC divisions and commercial subsidiaries, and provide day-to-day advice where required.

8.3.4 Governance

The BBC Board is responsible for overall oversight of the BBC's commercial activities. The BBC has set up a sub-committee of the Board, called the Fair Trading Committee, which is responsible for overseeing the BBC's compliance with its regulatory obligations for trading and separation between the BBC and its commercial subsidiaries. The committee has a requirement to review, approve and oversee the trading and separation arrangements for each of the BBC's commercial subsidiaries.

As set out in Section 2, the Commercial Holdings Board is the main governance body for the commercial subsidiaries and interfaces between the BBC Board and the commercial subsidiaries. Each of the commercial subsidiaries has an executive committee, which is in charge of day-to-day running of the subsidiary. The Commercial Holdings Board approves the BBC Commercial Group's strategy, and that of each commercial subsidiary. It is accountable to the BBC Board for ensuring it complies with fair trading obligations.

In October 2017, the BBC expanded the role of the BBC Commercial Holdings Board to also ensure oversight of the operations and performance of the subsidiaries. This Board consists of nine directors, of which four are BBC Group executive directors, another four are executives from the commercial subsidiaries, and one non-executive member.

The BBC has published information on the roles of the different boards and committees within the BBC Group to help improve the transparency of the governance arrangements with regards to operational separation¹⁴³. This information sets out:

- ▶ Structure, roles and responsibilities of different boards and executive committees in relation to the BBC's commercial activities;

¹⁴³ BBC, [online]. Available at: <https://www.bbc.co.uk/corporate2/insidethebbc/whatwedo/commercialbusiness>

- ▶ A list of who sits on each board and executive committee – i.e. names and job titles; and
- ▶ Terms of reference for the BBC Board, Executive Committee, Commercial Holdings Board, each commercial subsidiary's board and executive committee.

The BBC also intends to publish guidance on conflicts of interest and information sharing at the BBC Board and Exec committee level.

As part of this review, we obtained and reviewed the terms of reference for the BBC Commercial Holdings Board, which sets out the responsibilities of the Board. The BBC Commercial Holdings Board approves the BBC Commercial Group's strategy and the strategy of each individual commercial subsidiary. The membership of the Board includes the BBC's Director General (who acts as chair), the Deputy Director General, two non-executive directors and six senior BBC executives, the majority of whom represent the commercial subsidiaries. There are approximately seven planned meetings of the Board each year.

8.3.5 Findings

Based on our review of the BBC's arrangements in relation to operational separation, we note the following:

- ▶ The BBC has set up separate commercial subsidiaries that aim to make a profit. This is demonstrated by the annual accounts submitted to Companies House. Further, BBC Commercial Holdings Limited publishes statutory annual consolidated accounts and submits these to Companies House.
- ▶ There is also evidence in the commissioning guidelines that when new BBC productions and programmes are commissioned, a competitive process is applied, with no undue bias towards Studios. This process ensures that Studios does not gain an unfair advantage and must go through the competitive process as any other competing producer does.
- ▶ The BBC also has established flow of information controls to ensure that the commercial subsidiaries do not gain access to information that other market participants do not have. These processes include conflict of interest procedures, written guidance on information sharing, the use of non-disclosure agreements, access constraints to IT systems and information for subsidiary employees, and fair trading training. We are satisfied that these controls are robust, following our review of the Deloitte Fair Trading Audit report and our interviews with BBC staff. Although there is always a risk of sensitive information being transferred across the Group, we believe the processes in place are proportionate to the risk involved.
- ▶ We also note that the current governance arrangements within the BBC show that each commercial subsidiary has its own board and executive committee. This indicates that the BBC operates a degree of arm's length separation between the BBC and the commercial subsidiaries. The BBC has published information to make these governance arrangements more transparent.

8.4 Supply and pricing of goods and services

8.4.1 Ofcom requirements

Where the BBC provides goods and services to commercial subsidiaries, it must ensure the transactions are made on an arm's length basis, and in a manner that does not unduly discriminate against third parties. Examples of goods and services provided to the commercial subsidiaries include the use of commercial rights for content, licences to BBC-owned technology, and studio and office space. The BBC may supply goods and services solely to the commercial subsidiaries only where there is a clear reason for such exclusivity. For example, the BBC is not required to provide "business support services" – such as payroll, IT, HR, legal and finance services – to the wider market.

Where the BBC provides goods and services to the wider market, these should be offered on equivalent terms to those offered to the commercial subsidiaries. Ofcom requires prices to be set using an open market process (e.g. competitive tendering) where appropriate. Where this is not possible, it should use verifiable comparable information on prevailing market practices. Where there are no relevant market benchmarks or evidence on market practice, it should adopt a cost-based approach, which should cover:

- ▶ All relevant direct costs in providing the goods and services; and
- ▶ An appropriate contribution to the relevant overheads and capital costs and an appropriate contribution for reinvestment in public service activities.

In cases where incremental cost pricing conforms to market practice, the BBC should ensure that prices are based on the incremental costs of providing a good or service. It must not set prices below incremental cost under any circumstances. Pricing methodologies, terms and conditions should be regularly reviewed and consistent approaches should be in place for similar goods and services, including agreements for the use of the BBC brand. These requirements set out by Ofcom do not apply to pricing of tickets for certain events listed in the Agreement¹⁴⁴.

The BBC is required to publish transfer pricing methodologies that outline the overall approach to transfer pricing, including where and how cost-based pricing is applied. It does not have to publish actual transfer prices that could affect commercial confidentiality, for example the price of secondary rights paid by Studios.

In its recent consultation, Ofcom has proposed some modifications to parts of the 2017 requirements outlined above. The proposals will allow for different approaches to be taken for transfer pricing, depending on the nature of the goods and services provided and the specific competition concern. Ofcom is committed to the view that prices for goods and services should be based on market prices or benchmarking, with a fall-back option of using costs where these are not appropriate. In relation to business support services that the BBC provides to its commercial subsidiaries, Ofcom is proposing that prices should be based on the long-run cost of provision.

8.4.2 BBC policies

The BBC has published its fair trading policies on its website. These include a high-level document covering the principles of transfer pricing between the BBC and its commercial activities. The BBC has also published group trading manuals for each of the three main commercial subsidiaries, and also policy documents that outline the use of the BBC's brand for each of the subsidiaries.

8.4.2.1 Transfer pricing

The BBC published an updated version of its principles for transfer pricing in April 2018¹⁴⁵. In it, the BBC outlines its overall approach to transfer pricing between the BBC and the commercial subsidiaries. It follows the overarching principle that the BBC's commercial subsidiaries should receive no unfair advantage as a result of their relationship with the UK Public Services, trading activities and non-service activities.

The document explains that the BBC seeks firstly to establish a market-based price for all goods and services provided by the BBC or one of its commercial subsidiaries. The BBC determines this by:

¹⁴⁴ BBC Agreement, Section 49 (4h)

¹⁴⁵BBC, [online]. Available from:

http://downloads.bbc.co.uk/aboutthebbc/insidethebbc/howwework/policiesandguidelines/pdf/transfer_pricing_principles_april_2018.pdf

- ▶ *Using the price the BBC pays to third parties who provide services to the BBC following a competitive tender process. The BBC tenders for services like IT or HR.*
- ▶ *Using the price the BBC has paid for obtaining wider services in the market. The BBC does not exist in isolation and competes with third parties to obtain services, outwith a formal competitive tender exercise. For example, if the BBC buys commercial property it has to compete in the wider property market and pay a 'market' price¹⁴⁶.*

Where it is not possible to determine a market price, or where the BBC wants to verify the accuracy of a market price, it uses benchmarks to set a transfer price. The following approaches are adopted by the BBC:

- ▶ Regular internal benchmarking exercises called "Compete or Compare" where the BBC uses competition to achieve value for money or external benchmarking.
- ▶ Where benchmarks are used, a range of prices is developed rather than a single price point. The BBC then compares its costs to this range to understand whether it is an appropriate market based benchmark.
- ▶ The BBC will either benchmark the price for a good or service, or benchmark the component parts of the inputs that make up the service.
- ▶ For employees, the BBC and its commercial subsidiaries compete in the open market to hire staff. They therefore consider the salaries of staff to be the market price. The BBC also benchmarks its remuneration packages, to ensure that they remain consistent with market rates.

Where it is not possible to use market-based pricing or benchmarking, the BBC uses a cost-based approach. This is determined by the direct costs of providing a service, with an appropriate level of overheads allocated. The BBC does not have a market based cost of capital, and therefore the BBC does not include a profit or return on capital charge within these costs.

Once a transfer price has been agreed for a good or service that is traded between the BBC and a commercial subsidiary, the BBC then charges this price based on the use of the good or service. For example, if a commercial subsidiary uses the BBC's IT systems, the BBC determines the market price based on the terms of the contract with the third party provider. This price is then allocated to the commercial subsidiary based on the level of service and the volume used by the subsidiary. Where possible, the BBC passes through third party costs directly back to the ultimate recipient of the good or service, rather than allocate them at a group level. These principles are reflected in more detail in service level agreements and property licenses that the BBC has put in place.

Where services provided relate to people employed by the wider BBC Group carrying out work for a commercial subsidiary, the BBC allocates the price based on time spent working with the commercial subsidiary. Where appropriate, the BBC manually records the time spent by employees who work part-time for the commercial subsidiaries, in order to calculate the percentage of time spent related to their contractual hours in their employment contract.

When the BBC provides a good or service to both the commercial subsidiaries and third parties, it will use the same methodology and expect to charge the same prices, if comparable. The BBC only expects to provide services to third parties when they are not widely available on the market, for example the BBC archive services. The BBC does not have any plans to offer access to services to the wider market in wider corporate functions, such as HR, IT and legal services.

¹⁴⁶ BBC, 31 October 2017, *Principles for Transfer pricing*, pg. 2

8.4.2.2 Group trading manuals

The BBC has published a set of group trading manuals for each main commercial subsidiary, covering Studios, Studioworks and Global News¹⁴⁷. The manuals contain the arrangements that the BBC has implemented in order to set charges for the goods and services that are supplied to the commercial subsidiaries and for the goods and services that the subsidiaries provide to the rest of the BBC. The latest set of group trading manuals were published in April 2018, in line with Ofcom guidelines.

Using Studios as an example, the BBC updated the trading manual during 2017/18 following the merger between Studios and Worldwide. It decided to split its operations into a distribution arm (formerly Worldwide) and a production arm (formerly Studios). The total number of goods and services which are offered from the BBC to Studios is 49. The majority of these relate to support services (e.g. HR, Finance and IT). Studios has offered four services to the BBC, relating to archives, content rights management, finance and Simultaneous European Relay (SER).

Each service has a different price basis, rationale and apportionment methodology depending on the type of service. The price basis covers the categories outlined in the principles to transfer pricing, i.e. market price, benchmarking or cost-based pricing.

The BBC is also required to publish updated versions of the group trading manuals annually. They must publish all amendments from the previous version, including any material amendments to the charging methodologies. This includes a rationale for why the transfer price has been calculated using the selected price basis. The apportionment methodology outlines how the transfer price is allocated to the subsidiary, based on the appropriate volume of the good or service used.

The BBC also published guidance¹⁴⁸ on how each subsidiary uses the BBC brand, and the methodology for calculating the appropriate fee for using the BBC brand. We note that all of the subsidiaries pay a brand fee based on a revenue royalty, which we consider to be a reasonable approach. The BBC states that the terms of the brand licence and the brand fee percentage have been reviewed by independent financial external advisors, who confirm that the payment has been set on market standard terms.

In its response to Ofcom's consultation, the BBC has proposed to simplify its current publication of transfer pricing information by producing a single document which outlines all transfer pricing methodologies. This proposal would reduce some of the duplication of the group trading manuals.

8.4.3 BBC processes

The Fair Trading Committee approves all transfer pricing policies, and the transfer pricing principles outlined above. The committee has also implemented a process for resolving internal disputes about transfer pricing, and will aid in responding to any external complaints about transfer pricing. The BBC's complaints framework outlines that the BBC will do everything reasonable to resolve any complaints related to transfer pricing¹⁴⁹. We outline the BBC's complaint process in the box below.

¹⁴⁷ BBC, [online]. Available from: <http://www.bbc.co.uk/corporate2/insidethebbc/howwework/policiesandguidelines/fairtrading.html>

¹⁴⁸ BBC, [online]. Available from: <http://www.bbc.co.uk/corporate2/insidethebbc/howwework/policiesandguidelines/fairtrading.html>

¹⁴⁹ BBC, [online]. Available from: https://ssl.bbc.co.uk/complaints/forms/assets/complaintsnew/resources/BBC_Complaints_Framework.pdf

BBC procedure for regulatory complaints

A regulatory complaint in relation to the commercial subsidiaries would cover whether *“the BBC has breached requirements which Ofcom considers appropriate to ensure that the BBC’s commercial activities do not, as a result of their relationship with UK Public Services, trading activities, or non-service activities, distort the market or gain an unfair advantage”*¹⁵⁰.

A regulatory complaint will initially be reviewed by the Executive Complaints Unit (“ECU”) within the BBC. The BBC’s response will be issued by a senior BBC employee who has had no prior involvement in the issue covered in the complaint. Other BBC teams may be involved in the investigation as required. The BBC will also notify Ofcom of any regulatory complaint it receives and is actively investigating. The BBC aims to answer or acknowledge complaints within 10 working days. It may also ask for additional information from the complainant so that it can fully investigate the complaint. The BBC also expects that the deadline for a full response to a complaint should be no longer than 35 working days. However, if an investigation requires more time, the BBC will be clear on the updated deadline to the complainant.

The BBC will send the complainant a written response which outlines whether it accepts or rejects the complaint. When the complaint has been upheld or resolved, the ECU will publish a summary of the complaint on the complaints page of the BBC website. If the BBC accepts the complaint it will outline what remedial actions it has taken in its response and in the published summary of the complaint. If the BBC decides not to investigate the complaint it will explain why to the complainant. In the majority of cases the complaint should normally be made to the BBC first. In exceptional circumstances, complaints can be made directly to Ofcom rather than the BBC, but complainants should explain to Ofcom their reasons for not making the complaint to the BBC. If the complainant is unhappy with the BBC’s response, the complaint can be referred to Ofcom. A complaint may be referred to Ofcom if:

- ▶ The complainant is not satisfied with the resolution of a complaint by the BBC;
- ▶ The complainant feels that Ofcom should impose a sanction on the BBC; or
- ▶ The BBC has failed to resolve the complaint within the time period set out.

Ofcom has provided various channels for referring a complaint to them including post, email, its website and telephone.

The BBC will also review its transfer pricing methodologies and arrangements on an ongoing basis. It has for many years commissioned an annual external Fair Trading Audit, of which an opinion is published in the BBC’s Annual Report. We cover the Fair Trading Audit (as performed by Deloitte in 2017/18) in more detail in Section 8.7.2.

The BBC also publishes new versions of the group trading manuals for each main commercial subsidiary on an annual basis. When any material changes are made, the BBC publishes details of the changes with a corresponding impact statement.

8.4.3.1 Internal audit: regularity report

The BBC Royal Charter introduced the concept of regularity for the BBC, and requires the Comptroller and Auditor General to issue an opinion on regularity issues¹⁵¹. Regularity is defined in the Royal Charter as requiring that *“the management of all of the BBC’s resources*

¹⁵⁰ BBC, *Complaints framework*, pg. 36

¹⁵¹ BBC Charter, Section 39 (1)

*must accord with the provisions of the Charter, Framework Agreement and other agreements the BBC enters into with Government Ministers*¹⁵².

Prior to the NAO issuing an audit opinion on the financial statements and regularity, the BBC's internal audit team conducted its own review of regularity issues. Not all of the regularity internal audit scope covered issues relating to financial and operational separation, but the internal audit team did review whether licence fee funds were being used to fund commercial activities and whether the BBC has made material changes to its activities that have not been approved by Ofcom.

The internal audit team concluded that *"we have not identified transactions that, in our opinion, could be considered as irregular"*¹⁵³. They did however recommend several management actions which BBC management agreed to implement – for instance relating to logging regularity requirements and monitoring spend.

The internal audit review of regularity provides additional evidence for assessing whether the BBC is complying with its requirements with regards to transfer pricing. We cover the NAO's external audit of regularity – which concluded that the BBC has complied with regularity requirements – in Section 8.7.3.

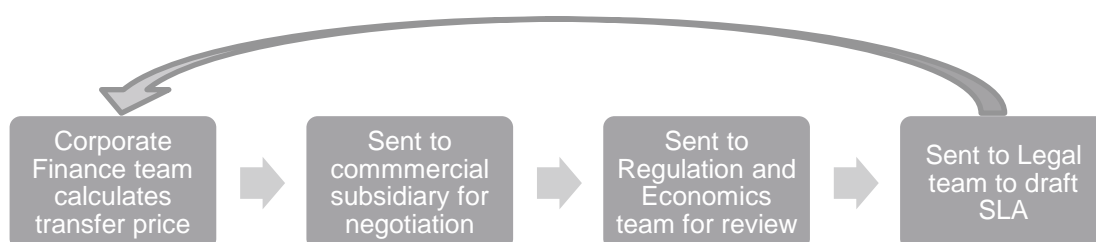
8.4.3.2 Internal commercial agreements, including Service Level Agreements ("SLAs")

In 2018/19, the BBC reviewed its existing internal commercial agreements, updated its group trading manuals, and updated its SLAs. This included identifying any gaps where transactions between the BBC and commercial subsidiaries were not covered by an SLA. The implementation process was led by the Corporate Finance team within the BBC Group, who liaised with various stakeholders including the Chief Financial Officers ("CFOs"), finance teams, and legal teams within the commercial subsidiaries. This process involved weekly meetings between the Corporate Finance, Legal and commercial subsidiary teams to draw up SLAs where they were not already signed and agreed, and also to revise existing SLAs. The process was iterative and involved negotiations between each of the various teams until agreements could be reached. In addition, the BBC prepared group trading manuals for Global News, Worldwide and Studioworks.

In the context of the SLAs, the process for agreeing transfer prices is illustrated in Figure 6 below.

Figure 6: SLA implementation process

Source: EY illustration



Under this process, the Corporate Finance team prepares a draft transfer price. This is sent to the commercial subsidiary who can either negotiate or accept the price. This transfer price may be revised iteratively until an agreement is reached. This final transfer price is sent to the Regulation and Economics team for review of the methodology, and it is finally passed to the Legal team who prepare a draft SLA. The draft SLA is then reviewed by the Corporate Finance team, commercial subsidiary and Regulation and Economics team until a final version is ready for signature.

¹⁵² BBC Charter, Section 16 (2)

¹⁵³ BBC, 6 June 2018, *Regularity Update*, BBC Audit and Risk Committee

Agreed transfer prices, as set out in the group trading manuals and the SLAs for the goods and services, are charged quarterly. This charging process is done automatically by the accounting system, which allocates the transfer price via an internal recharge to each commercial subsidiary. Any goods or services provided by the commercial subsidiaries to the BBC, or each other, are also internally recharged through the same quarterly process. Further, the Corporate Finance team monitors the application of the SLAs throughout the year; and the year-end process involves a true-up to ensure that correct charges have been allocated throughout the year.

The implementation process carried out by the BBC provides evidence that Ofcom's requirements are being followed correctly. The process has involved negotiations, review and sign-off of all transactions between the BBC and the commercial subsidiaries. We note that the constant review and negotiation of transfer pricing should ensure that any inconsistencies and refinements in methodology should be implemented over time.

We have not carried out a detailed review of transfer pricing, but we have reviewed the specific approach to calculating transfer prices within selected SLAs. We are comfortable that the approaches we have reviewed are in line the group trading manuals, that the transfer pricing was conducted on an arm's length basis, and that the BBC negotiated a fair market price.

8.4.4 Governance

The BBC has established the Fair Trading Committee, as a sub-committee of the BBC board, which has overall responsibility for ensuring Ofcom's guidelines on transfer pricing are followed. The Committee is responsible for assisting the BBC Board in complying with Ofcom's trading and separation regulatory requirements.

Members of the committee are appointed by the BBC Board, after recommendation from the Nominations Committee. The Fair Trading Committee must also consist of three non-executive directors of the Board at a minimum – with the Committee currently comprising four non-executive Directors. The Chairman of the BBC Board, Deputy Director-General, the Director of Policy and the Head of Regulation and Economics are invited to attend meetings. Other individuals may be invited to attend all or part of committee meetings when appropriate. The BBC Company Secretary also attends as a secretary to the Committee.

The Fair Trading Committee's terms of reference set out the core responsibilities of the Committee:

- ▶ Consider reports on the extent to which the activities of the BBC are consistent with Ofcom's trading and separation requirements;
- ▶ Keep under review the BBC's compliance with Ofcom's trading and separation regulatory requirements and any guidelines or guidance issued by the Board to support compliance with Ofcom's regulatory requirements;
- ▶ Consider the submission relating to trading and separation matters for inclusion in the Annual Report and Accounts, in advance of that report being submitted to the Board;
- ▶ Commission the annual Independent Audit of compliance controls;
- ▶ Consider and approve for publication the BBC's transfer pricing methodologies;
- ▶ Ensure that the BBC's transfer pricing methodologies are reviewed regularly; and
- ▶ Review and monitor matters arising from the Committee¹⁵⁴.

¹⁵⁴ BBC, [online]. Available from: http://downloads.bbc.co.uk/aboutthebbc/insidethebbc/managementstructure/seniormanagement/subcommittee/pdf/bbc_sub_committee_fairtrading.pdf

The Committee must meet a minimum of twice a year, but has generally met quarterly since being established. The terms of reference also set out that the Committee should annually review its own performance and the terms of its existence, and recommend any changes to the BBC Board for approval. The Committee chair must also formally report to the BBC Board at least once a year, covering all matters that fall under its responsibilities.

8.4.5 Findings

Based on our review of the BBC's arrangements in relation to supply and pricing, we note the following:

- ▶ We have reviewed the principles of transfer pricing, and note that the BBC has complied with the Ofcom requirement to publish the methodologies applied to transfer pricing. We have also reviewed the group trading manuals, which are also required to be published as part of Ofcom's requirements.
- ▶ We have also reviewed evidence of the Fair Trading Committee approving the principles and group trading manuals on a regular basis. The existence of the Fair Trading Committee is in itself a control that helps the BBC to comply with the requirements set by Ofcom. We have obtained and reviewed the terms of reference for the Committee and minutes of their meetings. The Fair Trading Committee has appropriate membership, consisting of entirely non-executive directors. This should ensure that there are independent views on whether the BBC complies with its requirements.
- ▶ The BBC's internal audit team, under direction from the Audit and Risk Committee, prepared a review of regularity prior to the NAO's audit report. This review noted no material issues. This provides us with additional evidence that Ofcom's guidelines on transfer pricing are being followed.
- ▶ We have also obtained examples of SLAs, which underpin the group trading manuals. These SLAs are legal contracts between the BBC and its commercial subsidiaries, which outline the specific methodology and rate cards for goods and services that are transferred between the BBC and its commercial subsidiaries. The BBC's process to implement SLAs for every intra-group transaction also highlights that there has been scrutiny of whether the BBC complies with the regulatory requirements.
- ▶ We have not carried out a detailed analysis of transfer pricing between the BBC and its commercial subsidiaries. We have, however, obtained an understanding of the principles and group trading manuals. The examples of SLAs provided by the BBC, and the overview of the process to implement the SLAs between the BBC and the commercial subsidiaries provides evidence that the BBC is complying with the requirements set by Ofcom.

8.5 Commercial rate of return

8.5.1 Ofcom requirements

The BBC's commercial activities must make a commercial rate of return. The regulatory framework requires that the commercial activities should earn a commercial rate of return in order to ensure that:

- ▶ BBC public funding is not used to subsidise a loss-making commercial activity; and
- ▶ Commercial activities are undertaken on an arm's length basis and in accordance with normal market principles (which Ofcom assesses at a line of business level).

The BBC is required to inform Ofcom annually, before 1 April each year, of the forward-looking commercial rates of return for each subsidiary and line of business. Ofcom assesses the level of return by considering whether a rational private investor would invest in the activity given the level of risk. It does not expect commercial activities to make a profit every year but does expect a commercial return to be generated over an appropriate period of time. Ofcom has also stated

that it will not specify target rates of return for each of the commercial subsidiaries, and these should instead be quantified by the BBC based on market conditions.

The BBC must inform Ofcom of any line of business that is not making a commercial rate of return. It must also assess the appropriate level of return for each line of business through benchmarking. Where a line of business is not making a commercial return, the BBC must review its performance and consider steps required to move to earning a commercial rate of return. Where this is not possible, it should decide whether the activity should be modified, scaled back, stopped or divested. If the BBC decides to continue with the line of business, it must outline in its business plan when it will return to making a commercial rate of return. Ofcom can request access to supporting evidence to ensure that the business plan is realistic.

In its July 2018 consultation, Ofcom is proposing to alter the regulation to state that the BBC must earn a commercial rate of return over an appropriate period of time. If over that period the BBC does not believe a commercial rate of return will be generated, it must take appropriate steps to achieve a commercial rate of return.

Ofcom is also proposing that each main commercial subsidiary must earn a commercial rate of return, as well as at line of business level. Ofcom also intends to update its information requirements, being more specific on the supporting information it requires regarding rates of return, and what should be published publicly.

The BBC, in its response to Ofcom's consultation, stated that it believed it important that the BBC is given freedom to set its own internal targets, including stretch targets of performance. These would be higher than the "minimum" or "commercial rate of return" that Ofcom would monitor, as a floor, to ensure there is no inappropriate subsidy to commercial activities in the form of tolerance of financial performance that is below commercial levels.

8.5.2 BBC policies

The BBC's policy is that all commercial subsidiaries must be commercially efficient in line with the commercial criteria and Ofcom's requirements. It expects all of its subsidiaries to earn a commercial rate of return, including at a line of business level. Any subsidiaries which do not earn a commercial rate of return will put in place an action plan to recover the position.

The BBC sent its first forward-looking commercial rate of return forecast (for financial year 2017/18) in October 2017. The BBC then submitted 2018/19 forecast figures (including benchmarking on rates of return for each line of business) to Ofcom on 29 March 2018. Based on historic statutory account information, the BBC concluded that all lines of business were making a commercial rate of return. This forecast contains commercially sensitive information and so was not made publicly available. In its first forecast sent to Ofcom, the BBC confirmed that EBITDA margin is the rate of return used. We discuss the BBC's choice of metric in Section 6.3.4.

The BBC monitors performance of each line of business throughout the year and will inform Ofcom when any line of business is not making a commercial rate of return. Any decisions about the future of any line of business (for example whether an activity should be stopped or divested, in the event that it is not making a commercial return) will be made by the BBC Commercial Holdings Board and ultimately signed off by the BBC Board.

8.5.3 BBC processes

In relation to actual financial performance, the BBC's internal processes and controls are designed to ensure that EBITDA figures are prepared each year on a timely and accurate basis. This headline EBITDA figure is also reported quarterly for each commercial subsidiary in the reports sent to Ofcom. Each commercial subsidiary has its own internal finance team who perform the necessary day-to-day financial record keeping and accounting. Consolidated statements for the Commercial Holdings Board are prepared by the Group Finance team and individual draft year-end financial statements for audit are prepared by the individual subsidiaries.

The individual year-end financial statements (which contain actual EBITDA commercial rates of return for the year) are prepared and then signed by a relevant director and submitted to Companies' House once the NAO has issued an audit opinion.

The forecast commercial rates of return for the coming year are also submitted by 1 April, in line with Ofcom's requirements. These forecasts are prepared each year based on forecasts set as part of the annual budget process. Each subsidiary prepares an annual plan and budget which will include a target EBITDA for the year ahead. This annual plan and budget is approved by the board of each commercial subsidiary. The Regulation and Economics team is involved throughout this process, and is ultimately responsible for submitting the information to Ofcom once approved by the BBC Board.

While the BBC has submitted forecast information to Ofcom, we note that there was a lack of clarity in relation to the information that the BBC is required to submit. Specifically, our understanding of the regulatory requirements is that the BBC is obliged to submit a forward-looking commercial rate of return measure to Ofcom, informed by market benchmarking – in line with the BBC's understanding, this commercial rate of return measure should provide a "floor", such that internal BBC targets are set at or above this level. However, we understand that the BBC has submitted its internal forward-looking targets to Ofcom, alongside the commercial rate of return targets based on external benchmarking. We understand that the BBC is clarifying information requirements with Ofcom in the context of Ofcom's recent consultation into trading and separation.

8.5.4 Governance

Annual accounts which contain historical EBITDA and commercial rates of return are approved by the Board of each subsidiary. It is the responsibility of each commercial subsidiary board to ensure there are appropriate controls and processes in place to prepare statutory financial statements in line with applicable accounting standards. They also are required to oversee the subsidiary's operations on a day-to-day basis to ensure that it maintains a commercial rate of return.

The BBC Board has ultimate responsibility for approving the forward-looking commercial rate of return, as part of the annual budgetary process, and in line with the reporting requirements defined by Ofcom.

8.5.5 Findings

Based on our review of the BBC's arrangements in relation to earning a commercial rate of return, we note the following:

- ▶ The BBC provides Ofcom with an annual submission of forward-looking commercial rate of returns, which has included the BBC's internal targets. We have noted that the BBC is clarifying information requirements with Ofcom.
- ▶ The BBC is required to submit internal financial information to Ofcom on actual performance. The BBC prepares quarterly financial reports which detail the quarterly financial position of each commercial subsidiary, which includes the year to date EBITDA figure, and variance analysis against the financial year target for each subsidiary. Any variances are then explained based on current performance and market conditions. These reports also indicate compliance with Ofcom's commercial rate of return requirements, as they show management's view of performance based on quarterly management accounts.

8.6 Material changes to commercial activities

8.6.1 Ofcom requirements

The BBC may decide that it wants to change the commercial activities that it carries out, and/or how its commercial subsidiaries operate. Ofcom has set out in its operating framework a list of requirements and processes that the BBC must follow in these circumstances.

The Agreement defines a material change¹⁵⁵ as:

“(a) the carrying out of a new type of activity as a commercial activity (for example, an activity previously carried out as a UK Public Service, non-service activity or trading activity); or

(b) a significant change to the BBC’s commercial arm,

where there is a significant risk that the change may, as a result of the relationship of the activity with the UK Public Services, trading activities or non-service activities, distort the market or create an unfair competitive advantage.”

The Agreement also states the BBC must publish a policy on how it will assess and consider material changes, and how it will consult with interested parties. The agreement sets out that the BBC must perform a “commercial test” on any proposed material change¹⁵⁶. The test outlines what the BBC has done to determine whether the proposed change meets the commercial criteria. The BBC is responsible for ensuring that the test is satisfied, and it must publish the proposed change and send a copy to Ofcom. Ofcom is entitled to receive a full confidential version of the proposal including all supporting documents. A non-confidential version of the proposal must be made available publicly.

The BBC must prepare a well-researched, well-evidenced and robust business plan for each proposed material change that demonstrates it will earn a commercial rate of return within the time horizon of the plan.

If the BBC does not satisfy these requirements, Ofcom can require the BBC to stop implementing the change in question.

8.6.2 BBC policies

The BBC has published a policy on material changes to the UK Public Services, non-service activities and commercial activities on its website¹⁵⁷. The policy outlines the BBC’s approach to assessing materiality of a proposed change, the commercial test and the process for informing Ofcom.

8.6.3 BBC processes

The BBC provides a high-level indication of material commercial changes for the coming year in its Annual Plan, subject to commercial confidentiality. In addition, we understand that each commercial subsidiary updates the Regulation and Economics team on any new planned initiatives at a monthly meeting. These monthly meetings allow the Regulation and Economics team to identify, at an early stage, any initiatives planned by the commercial subsidiaries that could require further assessment of materiality.

The BBC does not consult with stakeholders in deciding whether a change is material or not. The BBC will decide whether it needs to consult with stakeholders when it is assessing the proposal against the fourth commercial criterion. The BBC will consider whether a consultation is necessary based on the risk of harm to the BBC or the interests of its commercial partners.

The BBC considers a range of factors when deciding whether a proposal should be considered as a new type of commercial activity, or a significant change to the BBC’s commercial arm that would risk market distortion. These include:

- ▶ **Scale:** covering the level of investment required to support the proposal, in absolute terms and relative to the market;

¹⁵⁵ BBC Agreement, Section 23 (14)

¹⁵⁶ BBC Agreement, Section 24

¹⁵⁷ BBC, [online]. Available from:

https://www.bbc.co.uk/aboutthebbc/insidethebbc/howwework/policiesandguidelines/material_changes.html

- ▶ **Usage:** covering the expected change in usage and market share of the activity proposed;
- ▶ **Novelty:** covering whether the proposal involves entry into a new market or significant expansion in a current market;
- ▶ **Duration:** covering whether the proposed change is temporary or permanent; and
- ▶ **Geography:** covering whether the activity takes place in the UK or outside the UK.

The BBC is also required to assess whether the proposed change will alter the relationship between a commercial activity and the UK Public Services, trading activities and non-service activities such that there is a significant risk of market distortion or an unfair advantage. The BBC will undertake desk-based research and analysis to inform the assessment of materiality. This analysis is used by the BBC Board in deciding whether the potential change is material or not.

In carrying out the “commercial test”, the BBC must ensure that the proposed material change meets the four commercial criteria. The BBC will base its analysis on empirical evidence as appropriate. The BBC Board makes the final decision as to whether the proposal satisfies the commercial test and whether it has been conducted in accordance with the policy on material change.

When a decision has been made to proceed with the material change, the BBC will provide a full version of the proposal and details of the commercial test to Ofcom, including any supporting documents. Where any changes to the proposal have occurred during the commercial test, the BBC will provide Ofcom with a version that reflects these changes. The BBC must also provide Ofcom with a non-confidential version of the proposal suitable for publication. The BBC must also publish the non-confidential version of the proposal. If Ofcom asks for further information or seeks clarification, the BBC will agree a timeline for supplying this additional information, or explain why it cannot provide the information.

To date during the current Charter period, there have been no changes to BBC commercial activities that meet the definition of material change. However, we understand that the BBC implements processes to ensure it monitors and assesses potential material changes. This includes regular meetings between the Regulation and Economics team and the commercial subsidiaries, to discuss potential changes and to consider the materiality of those changes.

Further, the BBC Board considered whether the merger between Studios and Worldwide was a material change. The BBC Board assessed the merger against the test for a material change, as set out in the Agreement. We understand that the BBC identified potential risks of market distortion that the merger could give rise to, and then assessed the significance of these risks. Following this analysis and discussions with Ofcom, the BBC Board concluded that the change was not material. Further, Ofcom decided it would not be “*appropriate to conduct a formal assessment under the Agreement of the proposed change*”¹⁵⁸.

8.6.4 Governance

The BBC Board has overall responsibility for governance of the material change process. The Board must decide if a change is material and – in that event – if it passes the commercial test.

8.6.5 Findings

Based on our review of the BBC’s arrangements in relation to material changes, we note the following:

¹⁵⁸ Ofcom, [online]. *The merger of BBC Studios and BBC Worldwide: The BBC’s commitments*. Available at: https://www.ofcom.org.uk/data/assets/pdf_file/0014/112334/BBC_commitments_to_Ofcom.pdf

- ▶ The main documentation supporting the material change process comprises the policy on material changes to the BBC's UK Public Services and non-service activities and commercial activities, which is published on the BBC's website.
- ▶ There have to date been no changes that have required formal implementation of the policy. We note that the merger between Studios and Worldwide was considered in terms of whether it was a material change, with the BBC Board concluding that the change was not material and therefore that a referral to Ofcom was not required. This provides evidence that the material change process is being considered and followed by the BBC.

8.7 External assurance and scrutiny of the BBC's compliance with the regulatory framework

The BBC's operations and compliance with the regulatory framework are subject to significant external scrutiny – including by Ofcom and through a variety of audits in relation to whether the regulatory requirements have been followed. This includes the following:

- ▶ As part of its regulatory scrutiny of the BBC, Ofcom has considered whether the BBC has complied with the regulatory framework in relation to the commercial subsidiaries. We consider this scrutiny in more detail in Section 8.7.1.
- ▶ In relation to external assurance, an Annual Statutory audit is required by the Companies Act 2006, which covers the external financial statements of both the BBC Group and the BBC's commercial subsidiaries. Assurance is provided by an external auditor (in 2017/18 this was the NAO), who gives an opinion on whether the accounts give a true and fair view of the BBC's financial results and position. The audit report is published alongside the BBC's annual report and accounts¹⁵⁹.
- ▶ An independent Fair Trading Audit (currently performed by Deloitte on an annual basis), is commissioned by the Fair Trading Committee. This audit provides an opinion on whether the BBC has established and applied a system of internal controls that provide reasonable assurance that the BBC has complied with its fair trading arrangements during the financial year. The opinion is presented in the BBC's Annual Report¹⁶⁰. We cover this report in detail in Section 8.7.2.
- ▶ A regularity audit is required by the Charter and performed by the NAO. This audit gives an opinion on whether the income and expenditure transactions in the BBC's group financial statements have been applied correctly and if they comply with the operating framework, including the Charter and Agreement. This audit is performed annually and an opinion published in the BBC's Annual Report¹⁶¹. We cover the details of this audit in Section 8.7.3.
- ▶ The NAO has also conducted a landscape review of the BBC's commercial activities which sets out how the BBC organises its commercial activities and covers the key risks and challenges the subsidiaries currently face. This is considered in Section 8.7.4.

8.7.1 Ofcom scrutiny of BBC's compliance with framework

Earlier, we outlined Ofcom's July 2018 consultation into trading and separation. While Ofcom did not make a formal assessment of the BBC's compliance in this consultation, it outlined its reasons for proposing changes to the framework. We summarise these below:

¹⁵⁹ BBC, 11 July 2018, *Annual report 2017/18*, pg. 160-182

¹⁶⁰ BBC, 11 July 2018, *Annual report 2017/18*, pg. 121-122

¹⁶¹ BBC, 11 July 2018, *Annual report 2017/18*, pg. 123

- ▶ **Operational separation:** Ofcom stated that it believes that “*broadly speaking, the current operational separation requirements are fit for purpose in meeting our competition concerns*”¹⁶².
- ▶ **Exchange of Information:** Ofcom noted that “*Some stakeholders have raised concerns around information sharing between the BBC Public Service and commercial subsidiaries although these concerns have been general rather than specific*”¹⁶³. Ofcom goes on to suggest that the BBC could be more clearly focused on addressing the risk of the commercial subsidiaries having access to private information.
- ▶ **Governance:** Ofcom noted that there is limited information in the public domain that sets out the governance arrangements of the commercial subsidiaries and how their boards and executive committees interact with the BBC Board. Ofcom goes on to state that “*we consider that the governance of the BBC’s commercial subsidiaries could be more transparent*”¹⁶⁴.
- ▶ **Monitoring, reporting and transparency:** Ofcom has stated that “*we currently have no transparency regarding how the BBC Public Service charges third parties for the same goods and services that it may provide to the commercial subsidiaries*”¹⁶⁵. We note in this context that the BBC’s transfer pricing principles¹⁶⁶ state 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*”. Ofcom has noted that it understands that the BBC has SLAs in place where transfer pricing methodologies are used. The BBC has also provided Ofcom with information on the value of its transfer pricing arrangements. However, Ofcom stated that “*we currently do not have any transparency of how the actual transfer charges compare to the SLAs the BBC has put in place*”¹⁶⁷.
- ▶ **Fair Trading Audit:** Ofcom commented on the annual Fair Trading Audit carried out by Deloitte. Ofcom stated that it does not “*have a sufficient understanding of the scope of the work to determine whether the assurance it provides is adequate*”¹⁶⁸. Ofcom further states that “*the extent to which we can take assurance from the Fair Trading Audit is likely to be limited because the auditors do not report to us*”¹⁶⁹. We understand that the BBC has sent Ofcom the terms of reference for the Fair Trading Audit.

In addition, Ofcom published its first annual report on 25 October 2018. This report sets out Ofcom’s assessment of the BBC’s compliance with the regulatory requirements in the Operating Framework and Operating Licence. Overall, Ofcom stated that “*the BBC is generally delivering on its remit for audiences through the breadth and quality of its output*”, but noted the following points relevant to the fourth commercial criterion:

- ▶ Ofcom found that “*The BBC’s governance arrangements need to ensure sufficient separation between the BBC’s public service and its commercial activities*”.
- ▶ Ofcom noted that it has “*some concerns about the governance of the BBC’s commercial activities, which should be more transparent*”.

¹⁶² Ofcom, [online]. Available from: https://www.ofcom.org.uk/data/assets/pdf_file/0032/116969/BBC-commercial-trading-activities-requirements-guidance.pdf

¹⁶³ Ofcom, 30 July 2018, *Consultation on changes to Ofcom’s requirements and guidance*, pg. 16, paragraph 2.21

¹⁶⁴ Ofcom, 30 July 2018, *Consultation on changes to Ofcom’s requirements and guidance*, pg. 24, paragraph 2.54

¹⁶⁵ Ofcom, 30 July 2018, *Consultation on changes to Ofcom’s requirements and guidance*, pg. 45, paragraph 5.33

¹⁶⁶ BBC, [online]. Available from:

http://downloads.bbc.co.uk/aboutthebbc/insidethebbc/howwework/policiesandguidelines/pdf/transfer_pricing_principles_april_2018.pdf

¹⁶⁷ Ofcom, 30 July 2018, *Consultation on changes to Ofcom’s requirements and guidance*, pg. 45, paragraph 5.38

¹⁶⁸ Ofcom, 30 July 2018, *Consultation on changes to Ofcom’s requirements and guidance*, pg. 50, paragraph 5.67

¹⁶⁹ Ofcom, 30 July 2018, *Consultation on changes to Ofcom’s requirements and guidance*, pg. 50, paragraph 5.67

- ▶ Specifically, Ofcom noted its concerns about the lack of transparency in how the BBC *“manages potential conflicts that may arise in those situations where BBC Directors operate across both the public service and the commercial activities”*.

8.7.2 Fair Trading Audit

The BBC commissioned Deloitte to undertake a Fair Trading Audit and report to the Fair Trading Committee on its findings for the year ended 31 March 2018. The report¹⁷⁰ provides reasonable assurance on whether the BBC has complied with Ofcom’s trading and separation requirements as at 31 March 2018.

Deloitte took a risk-based approach to the Fair Trading Audit. This means that it focused on the key areas where issues would most likely occur, and sought evidence to confirm that the fair trading rules were designed and implemented effectively to mitigate the risks identified.

Deloitte reviewed individual cases from the BBC’s Fair Trading Enquiries Log¹⁷¹, and examined written records and interviewed relevant parties to obtain reasonable assurance that the system of internal control had been applied correctly. They also focused their testing on the areas of significant risk identified by the audit team, specifically around transfer pricing, separation arrangements, use of and payment for the BBC brand and the fourth commercial criterion to not distort the market through the BBC’s commercial activities. Deloitte also noted that it *“observed a culture of consultation and referral in respect of fair trading matters”*.

Deloitte’s audit opinion is published in the BBC’s Annual report which states that *“Based on the results of our procedures, in our opinion the BBC has established and has applied a system of internal controls that provide reasonable assurance that it has complied with Ofcom’s Trading and Separation requirements as at 31 March 2018”*.

This clean audit opinion provides us with some evidence that the BBC is complying with Ofcom’s trading and separation requirements. However, we note that the audit has been conducted on behalf of the BBC Board and therefore we cannot rely on the opinion as an external third party. We also note that the inherent limitations stated by Deloitte in its report also restrict the amount of assurance we can take from the audit.

8.7.3 NAO regularity report

As part of its annual audit of the BBC, the NAO must also consider regulatory issues in its regularity report that it prepares each year. The regularity report and opinion focuses on the ways in which the BBC Board gains assurance that the BBC is complying with its regularity framework. The NAO defines the regularity framework as containing:

- ▶ The Royal Charter for the continuance of the BBC;
- ▶ The Agreement between Her Majesty’s Secretary of State for Digital, Culture, Media and Sport and the BBC; and
- ▶ Other agreements the BBC has entered into with Government Ministers¹⁷².

The NAO conducted the regularity audit in accordance with the Financial Reporting Council’s Statement of Recommended Practice Note 10, *Audit of Financial Statements in Public Sector Bodies in the United Kingdom*. This approach can be summarised in Figure 7.

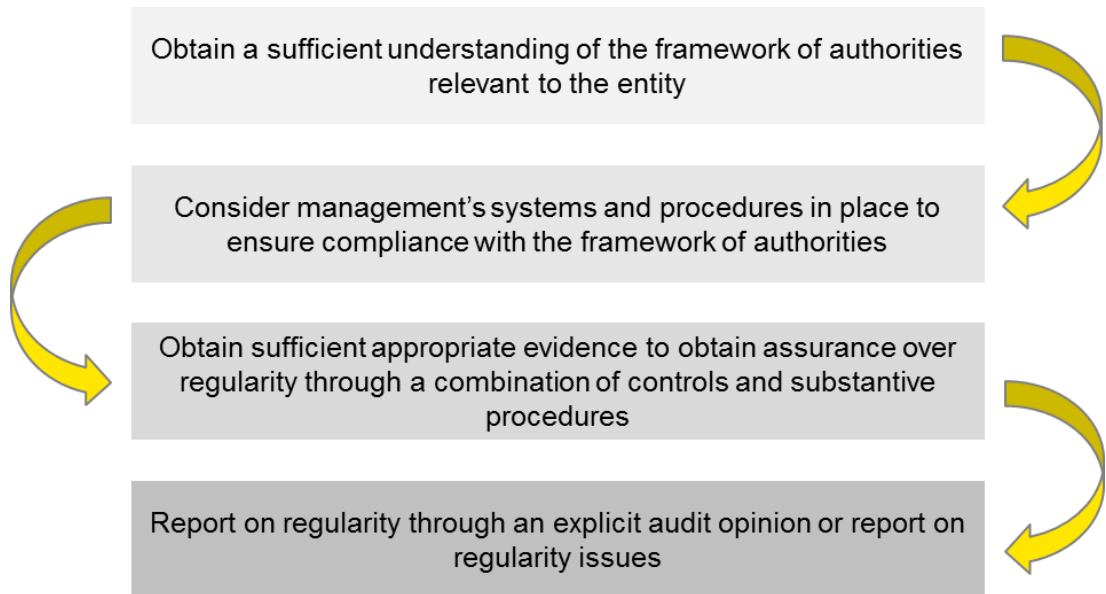
¹⁷⁰ BBC, 11 July 2018, *BBC Annual Report 2017/18*, pg. 122

¹⁷¹ The Fair Trading Enquiries Log contains every fair trading enquiry made in the BBC.

¹⁷² BBC, 11 July 2018, *Annual Report 2017/18*, pg. 169

Figure 7. NAO's approach to auditing regularity

Source: NAO Regularity audit update to the BBC Group Audit & Risk Committee, February 2018



- ▶ **Obtain a sufficient understanding of the framework of authorities:** The NAO assessed compliance with the Framework of Authorities – namely the Charter, Framework Agreement and other agreements entered into with Government Ministers). The NAO concluded the key risks from the framework of authorities are:
 - ▶ Risk of using licence fee money to fund commercial activities;
 - ▶ Risk of entering into transactions in relation to the BBC's activities that not been approved by Ofcom;
 - ▶ Completeness of agreements the BBC has entered into with Government Ministers and complying with these agreements;
 - ▶ Ensuring that the BBC's borrowing limits do not breach the levels set out in the Secretary of State Direction; and
 - ▶ Fraud arising within the group or mismanagement of BBC's assets leading to significant losses.

- ▶ **Consider management's systems and procedures in place to ensure compliance:** The NAO met with the BBC Policy and Governance teams to understand the controls put in place to ensure compliance with the Charter:
 - ▶ Creation of the Fair Trading Committee, establishment of the Fair Trading team, implementation of Fair Trading guidance and commissioning the Fair Trading Audit;
 - ▶ Engaging with Ofcom on the material change process;
 - ▶ Line by line analysis of the Charter and Framework Agreement to consider any new requirements introduced; and
 - ▶ The NAO concluded that they *"consider the BBC's systems and processes, as designed, should be adequate"*¹⁷³.

- ▶ **Obtaining sufficient appropriate evidence to obtain assurance over regularity:** The NAO stated it has focused on gathering evidence on the BBC's fair trading methodology,

¹⁷³ National Audit Office, February 2018, *Regularity report update to the Audit & Risk Committee*

Ofcom approval of material changes, the carve out of Studios, any commercial activities that do not gain a commercial rate of return, fraud and the implications for borrowing limits of acquiring stakes in third parties.

Following the completion of the regularity audit, the NAO published its opinion for the year 2017/18 in the BBC's annual report¹⁷⁴. The Comptroller and Auditor General did not note any material issues, and issued an unmodified opinion that stated:

"In my opinion, in all material respects, the income and expenditure recorded in the consolidated financial statements conform to the authorities which govern them."

The Comptroller and Auditor General also stated that the *"regularity opinion on the BBC Group financial statements considers whether licence fee funding has been used for its intended purpose, as set out in the framework of authorities"*.

8.7.4 NAO landscape review

The NAO conducted a landscape review of the BBC's commercial activities which sets out how the BBC organises its commercial activities and covers the key risks and challenges the subsidiaries currently face¹⁷⁵. The report was published on 7 March 2018. The scope of the report was as follows:

- ▶ How the BBC's commercial activities are organised, overseen and regulated;
- ▶ How the activities have fared in terms of their commercial performance and contribution to the BBC's public purposes; and
- ▶ How the BBC is responding to the opportunities and challenges its commercial activities face¹⁷⁶.

The NAO did not conduct a detailed value-for-money audit and did not draw an overall value-for-money conclusion, but did provide some comments on areas it expects the BBC to focus on in the future. We cover these comments in detail below:

- ▶ **Value creation:** The NAO concluded that the BBC has created value through its commercial activities to date, including financially in terms of returns and dividends and also contributing to achieving the public purposes. The commercial subsidiaries of the BBC are important to the BBC's performance and success as a result of the recent funding settlement with government and due to wider industry trends.
- ▶ **Developing new BBC-owned intellectual property to drive growth:** The report highlighted that owning intellectual property in the form of TV series and formats is a key cornerstone of the media industry. By merging Studios and Worldwide, the BBC has created opportunities to expand and exploit new intellectual property.
- ▶ **Setting meaningful targets to drive financial performance:** Worldwide was set a five year target to deliver £1.2 billion of financial returns to the BBC between 2017/18 to 2021/22. Following the merger, this target has not been revised. The NAO recommended that the target should be reviewed and set again following the merger.
- ▶ **Striking the right balance between paying dividends to the BBC and increasing investment in commercial activities:** The BBC Board should consider whether it should take a higher dividend to alleviate any financial constraints in the BBC. It could also increase funding by retaining profit in the commercial subsidiaries where there are opportunities to increase the value of BBC assets over the longer term. The BBC should

¹⁷⁴ BBC, 11 July 2018, *Annual Report 2017/18*, pg. 169

¹⁷⁵ National Audit Office, [online]. Available from: <https://www.nao.org.uk/report/the-bbcs-commercial-activities-a-landscape-review/>

¹⁷⁶ National Audit Office, 7 March 2018, *The BBC's commercial activities: A landscape review*, pg. 6

explain any decisions it makes in relation to the level of dividend and investment in the commercial subsidiaries.

- ▶ **Ensuring the Board and others have oversight, meaningful and consistent information about commercial subsidiaries:** The NAO recommended in its report that the BBC Board should act as a shareholder when making decisions about the commercial subsidiaries. It noted that the level of reporting and information that the Board needs for decision-making should be at a minimum the information required to be supplied to Ofcom on annual basis. The NAO however notes that it would expect wider information to be available to the Board to aid in decision-making. It also noted that the financial arguments for any decisions should be established and considered separately from public purpose considerations.
- ▶ **Embedding a new culture of transparency in the commercial subsidiaries:** The NAO noted that the Royal Charter sets out additional transparency requirements regarding the BBC's commercial activities. It recommended that the Board should acquire assurance that there is a consistent approach to transparency at each of the commercial subsidiaries but also at a group level, to ensure that the additional requirements are being complied with.

8.8 Conclusions and recommendations

Overall, we conclude that the commercial subsidiaries do not, as a result of their relationship with the UK Public Services, non-service activities or trading activities, distort the market or gain an unfair competitive advantage:

- ▶ **BBC policies:** It is evident that the BBC has conducted detailed analysis, reviewed Ofcom's requirements and aligned its policies to ensure it is complying with the regulatory framework. In particular, the BBC has published a range of policies, which provide external parties with an overview of how the commercial subsidiaries comply with the regulatory framework. For example, the BBC has published the principles it follows to comply with Ofcom's transfer pricing requirements, as well as detailed group trading manuals for each commercial subsidiary. It has also published a detailed policy on material changes to commercial activities. The BBC has also been complying with its reporting requirements and submissions to Ofcom.
- ▶ **BBC processes:** We consider that the BBC has embedded processes throughout the commercial activities to ensure it is complying with the requirements. We note that the requirements are still relatively new, and therefore there are areas where processes can still be improved or better implemented to improve efficiency. However, our view is that the processes currently in place ensure that the BBC is complying with its requirements. These include processes relating to operational separation, regulatory complaints, and internal commercial arrangements. In relation to commercial rate of return, we consider that there is scope for further clarity to ensure that the BBC supplies forward-looking commercial rates of return to Ofcom in a manner consistent with the requirements of the regulatory framework. We understand that the BBC is clarifying information requirements with Ofcom in the context of Ofcom's recent consultation into trading and separation.
- ▶ **Governance arrangements:** We consider that, in general, the governance arrangements in this area are appropriate and sufficient. For example, the BBC has in place a clear governance structure running from the BBC Board down to the individual commercial subsidiaries, and the Fair Trading Committee provides a clear decision-making body for issues relating to compliance with trading and separation requirements. We understand that the BBC's approach to governance reflects its understanding of the Charter obligations in relation to the role of the BBC Board and directors – notably that the Board's responsibilities cover both public service and commercial activities.

However, in relation to the supply and pricing of goods and services, the BBC should consider undertaking spot checks of transactions to review transfer prices. This would provide an additional test to ensure transfer prices are appropriate and proportionate.

9. Overall conclusions and recommendations

Overall, we conclude that the commercial activities carried out through **the BBC's commercial subsidiaries meet the four commercial criteria**. That said, there is scope for improvement in the BBC's application in certain areas. We recommend that the BBC monitors performance, and takes action where appropriate, in order to ensure ongoing compliance with the criteria. Below we summarise our conclusions and recommendations for the BBC.

9.1 Criterion 1: Fit with mission and public purposes

- ▶ Across the subsidiaries, we consider that the BBC's commercial activities fit with the mission and public purposes – and that this fit is embedded into the BBC's culture and practices.
- ▶ However, while the Agreement requires that commercial activities are *appropriate* to and *connected* with the mission and public purposes, these terms are not clearly defined – and there does not appear to be a consistent definition of these terms across the BBC. We consider that creating clear definitions for these terms would ensure consistent interpretation and application across the organisation.
- ▶ We recommend that the BBC considers the scope for more documentation in relation to fit with mission and public purposes – particularly in the case of Studioworks – in order to ensure that there is sufficient evidence to substantiate that this criterion has been explicitly considered.
- ▶ There may be scope for more consistency across the subsidiaries in the application of the criteria. Our observation is that each subsidiary follows its own processes, without reference to the practice of other subsidiaries. We expect that there may be scope for better knowledge sharing and alignment across subsidiaries. We note that this point applies across all four commercial criteria.

9.2 Criterion 2: Exhibit commercial efficiency

- ▶ We consider that each of the BBC's commercial subsidiaries exhibits commercial efficiency. Each has in place a clear strategy and budget plan. We have reviewed case studies for investment appraisal and have observed appropriate processes in place to consider the commercial efficiency of investments, and to ensure lessons are learned from less successful investments to better inform future decision-making. Based on our benchmarking and analysis of relevant contextual factors, we consider that each subsidiary is currently earning a commercial rate of return. However, we note that, to some extent for all of the main commercial subsidiaries, there are potential risks to the positive forecasts supporting our assessment.
- ▶ The commercial efficiency of Global News is finely balanced because the business operates in a challenging market. Its current activities correspond with the definition of commercial efficiency applied in this review, and so we consider that it is currently complying with this criterion. However, there may be challenges to the long-term commercial viability of the business. It is notable that Global News has recognised these challenges, and is implementing a strategy that seeks to address the changing market environment. Execution of this strategy – in order to secure sustainable profitability, and therefore ongoing commercial efficiency – should be a key area of focus for the BBC.
- ▶ While financial performance is tracked at the subsidiary and group level, we consider that there may be scope for more systematic and regular review at the BBC Group level in terms of historical, actual and projected performance (especially in the light of Ofcom's greater scrutiny of this area). We note that the regular material submitted to the BBC Board now contains more financial and contextual information on the commercial subsidiaries, and the CEO of Studios is a member of the BBC Board. That said, our interviews with BBC stakeholders indicate that there may be scope for the main BBC Board to monitor

the performance of the commercial subsidiaries more closely, in a way which is proportionate to their size and complexity.

- ▶ The BBC should consider benchmarking a useful tool to provide an indicative range to assess the performance of its commercial subsidiaries, but should also consider other factors (such as the changing market context and the particular characteristics of the BBC's commercial activities) when assessing whether a business is earning a commercial rate of return. In this context, we note that the Consumer Products line of business for Studios is particularly difficult to benchmark as a standalone activity. The BBC should therefore consider the most appropriate method for benchmarking its activities going forward.

9.3 Criterion 3: Not jeopardise the good reputation of the BBC or the value of the its brand

- ▶ We consider that the commercial subsidiaries are committed to safeguarding the BBC's reputation and brand, and are therefore complying with this criterion. We have not identified any specific occasions, practices or partnerships that risk jeopardising the BBC's reputation and brand.
- ▶ However, we note that each of the subsidiaries ensures compliance with the third commercial criterion in different ways, and there may be more scope for knowledge sharing and consistency, to the extent appropriate, between the subsidiaries. For example, Global News told us that it is following Studios' approach to ensuring compliance with the BBC's general ethics and compliance framework. There may be other such areas where consistency of approach across the subsidiaries is beneficial.
- ▶ In light of this, we recommend that the BBC carries out an internal study to understand how similar issues relating to reputation and brand are dealt with by different subsidiaries, to understand whether there is more scope for knowledge sharing.

9.4 Criterion 4: Not distort the market or create an unfair competitive advantage

- ▶ We consider that the BBC has appropriate policies, processes and governance in place to enable compliance with this criterion.
- ▶ In relation to supply and pricing of goods and services, we note that the BBC's arrangements meet Ofcom's requirements. However, we recommend that the BBC considers undertaking spot checks of transactions, to ensure its approach remains reasonable.

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