

## Chapter 3 - Achieving a Level Playing Field

### **Commercial Activities, Fair Trading and Privatisation**

**"Consider how to secure an appropriate balance between the BBC's public and commercial services, and review the mechanisms under which the fair trading commitment as to commercial services is delivered."**



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### Overview

It is often argued that the BBC's objectives as a public service broadcaster are directly in conflict with its declared aim to raise additional revenue from commercial activities. We do not believe that this need be the case. In fact, we see the commercial exploitation of the BBC's archive as wholly desirable from the point of view of the licence fee payer and likely to further the aims of broadcasting policy more generally. The archive has been under-exploited for too long.

The strategy of the BBC in this context should be to maximise revenues from commercial activities, subject only to two constraints:

- that the BBC as a whole preserves its public service ethos; and
- that it meets its fair trading commitment.

The first of these requirements takes account of the fact that, as commercial activities expand, there is a danger of an unintended feedback into the type of programmes which are made throughout the BBC. To put it simply, BBC producers may find it more attractive to make programmes with obvious commercial potential than to make programmes of a public service nature. The commercial tail might start to wag the public service dog.

However, we believe that there is little danger of this in the BBC of today. With commercial revenues accounting for under 4% of total expenditure, the public service culture remains overwhelmingly dominant. We are convinced that there is considerable scope to increase commercial revenues without threatening the public service culture of the BBC, and we would like to see greater emphasis being given to this aim by both the management and the Governors of the Corporation. Admittedly, much has been done in this direction in recent years. Nevertheless, the profit motive, correctly harnessed, could still be better used to raise extra funds for the public service.

In doing this, however, additional safeguards are necessary, not only to ensure that the BBC competes fairly in the private broadcasting market, but also to ensure that the BBC is clearly seen by the public to do so. Many of those who have submitted evidence to the Panel have described the BBC as non-transparent, and there is considerable concern that the BBC might abuse its dominant market position in the course of expanding its commercial activities. Again, the BBC has moved a long way in recent years both to develop fair trading safeguards, and to make its accounts and governance more transparent to the public. Nevertheless, more progress is needed on both these fronts.

With these considerations in mind, we make proposals designed both to inject a new climate of entrepreneurship into the BBC, and also to make the commitment to fair trading more transparent.

We accept that there is some tension between these recommendations, since the commitment to fair trading already limits the ability of the BBC's commercial bodies to earn profits. It would of course be far easier to earn enhanced revenues if there were less concern about fair trading. Alternatively, there would be less concern about fair trading if the BBC downplayed its commercial objectives. But this tension is the inevitable price to be paid for commercial activity in an organisation which is primarily funded by the licence fee. In the right circumstances, we think that this can become a creative tension.

The specific issues that have particularly concerned us are:

- Whether the BBC is organised in such a way that it can successfully exploit its commercial opportunities.
- Whether existing institutional arrangements are adequate to preserve the BBC ethos and to maintain fair trading.

We note that at the moment the BBC seems to experience the worst of both worlds. It is felt that it could earn far more revenue than it does today if it were better organised to do so; but at the same time it arouses great resentment from its commercial competitors who accuse it of unfair trading and there are fears about the destruction of its public service principles. This seems to us to raise particular questions about governance and we make a number of specific proposals.

#### **Fair trading or foul**

There are particular grounds for concern about the commercial activities of a broadcasting organisation which is primarily funded from the public purse. To see why this is the case, consider the following examples.

First, imagine a publicly funded broadcaster which makes a documentary about the solar eclipse, and shows it first on a free-to-air national TV channel. The programme is highly successful and, even after a repeat showing, there is a market for video sales, which are accomplished through the broadcaster's commercial arm. Later, it turns out that there is a demand to see this programme overseas, so it is sold to the broadcaster's joint venture in America. Finally, after several years, the programme reappears on History Gold, the broadcaster's domestic subscription channel. Each time the programme appears, the public service arm receives a fair market price for the programme.

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Later, it also receives the profits made by the commercial arm from the sales of the video, and the running of the programme on foreign and domestic subscription channels. The public service reinvests all this money in a new programme, "Mythology and Astronomy", which runs on the free-to-air national channel.

What is wrong with this process? The answer is absolutely nothing. Provided that the public service arm has genuinely received a fair market price for the programme, there has been no subsidisation of the commercial activities of the broadcaster by the licence fee payer. Therefore, no issue of unfair trading arises. Licence fee payers have clearly benefited overall from this series of transactions, even though some domestic viewers have paid a fee for the second showing of the solar eclipse programme on History Gold, or to buy the video. Not only does this enable them to view material which would otherwise be unavailable, but it also generates revenue from which all licence fee payers can subsequently benefit. In short, everyone gains.

Now consider a second example in which a less scrupulous public service broadcaster notices that there is a booming commercial market for sales of programmes about golf. This broadcaster uses public money to make a show featuring the wonders of new technology in golf club design. The show is a success, and the broadcaster now sells it at a suspiciously low price to its specialist sports channel, UK Golf. Not surprisingly, UK Golf finds it rather easy to sell advertising from golf manufacturers in the breaks during this programme. This and similar activity proves highly profitable. But unfortunately the leakage of advertising revenue greatly damages the private sector subscription channel, UK Fairways, which runs on cable TV. Booming profits from UK Golf are now remitted to the public service broadcaster which, flush from its golfing success, decides to repeat the dose with a brand new series called "Amazing New Tennis Racquets".

What is wrong with this second example? Obviously, just about everything. Licence fee money is used to make programmes of a type which could perfectly well be left to the private sector, so there is no "market failure" case for public funding. Not only that, but public money is used to subsidise programme sales to the broadcaster's commercial arm, which then clearly engages in unfair competition with a private sector channel. No doubt this sort of behaviour increases the dominance of the "public service" broadcaster in the television market, making various types of uncompetitive behaviour more likely in the future.

Now let us turn to a third example, which is more difficult. This time the public service broadcaster decides to launch a new service, a free-to-air digital channel, "Digimusic", covering all types of classical music. It applies to the Secretary of State for permission to use licence fee money to do this. After carefully considering whether this can be defined as a public service channel, the Government allows the venture to proceed. The channel is only a moderate success in artistic terms, but, because it is free-to-air, it drives out of business an already-existing private sector digital service, "Classics on Subscription". This channel was slightly lower-brow, but had been a popular success until "Digimusic" came along. Actually, its audience ratings were rather higher than those subsequently mustered by the public service alternative.

What is wrong in this third example? It is far from clear. Classical music is usually seen as a public service genre, so there is nothing obviously mistaken in the Government's decision to allow "Digimusic" to be funded by the licence fee. The public broadcaster is adamant that it must be allowed to deliver classical music to its licence fee payer in the way best suited to new digital technology. But the market was already providing something reasonably close to the public service alternative, and actually more popular than "Digimusic" proved to be. The shareholders of "Classics on Subscription" are obviously outraged that their risk capital has gone up in smoke because the public service broadcaster has been allowed to launch into its field.

The point of these examples is twofold. First, very similar-looking activities by the public service broadcaster - making programmes, showing them first on public television and then selling them in the private marketplace - can either be wholly compatible with the tenets of public service broadcasting, or wholly inimical to them. Second, it can sometimes be very difficult to draw the line between what is a legitimate public service channel, and what is an unwarranted (and apparently "unfair") incursion into private sector activity.

In any event, it is obvious that very real issues arise whenever a public service broadcaster enters the commercial arena and, as usual with competition matters, the devil is in the detail. In the real world - unlike in our first two examples - there are few open-and-shut cases. The route to success is based on a transparently fair regulatory regime, and we make appropriate proposals in this Chapter.

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### The current regime

Successive Governments have supported the Corporation's involvement in its commercial ventures, while stressing that the BBC's primary mission is - and must remain - one of public service. Such ventures should enable the BBC to exploit its considerable assets and are an important means of securing new income for its public service remit. The BBC Charter and Agreement, therefore, set out a framework for ensuring that commercial activities are funded, operated and accounted for separately from the public services; that they are subject to specific Ministerial approval; and that the BBC should report on its compliance with fair trading requirements, including arrangements to avoid cross-subsidy between the public and commercial services.

The BBC has in fact engaged in commercial activities since the launch of the *Radio Times* in 1923, and the object has been to support the Corporation's public purpose. The commercial activities aim to do this by:

- helping maximise the value of licence fee funded programme assets;
- generating extra income to reinvest in core programming; and
- extending BBC services into new markets.

The activities are based around three key principles (set out in the *BBC's Commercial Policy Guidelines* - revised version published May 1999). These are that:

- commercial activities must be consistent with, and supportive of, the BBC's core purposes as a public service broadcaster;
- the BBC must always trade fairly; and
- the respect in which the BBC brand is held must not be diminished.

The BBC aims to ensure that commercial activities reflect the Corporation's core values, through their quality, distinctiveness and integrity.

Scope for commercial activity is currently restricted by various mechanisms. The principles outlined in the *Commercial Policy Guidelines* are echoed in the *Fair Trading Commitment* which also requires commercial activities to arise from and support BBC programmes, to comply with legal and regulatory requirements, and to offer the prospect of generating significant funds for reinvestment in BBC programmes.

## Commercial activities

Most of the BBC's commercial activities are carried out by BBC Worldwide Ltd, a wholly owned subsidiary of the BBC. BBC Worldwide was established in 1994 to operate the Corporation's range of commercial media interests. The rationale is that BBC Worldwide provides the best means of maximising long-term value for the licence fee payer by:

- building equity over time, rather than losing assets for short term gain; and
- protecting BBC editorial standards, and with them brand value.

Three main steps have been taken to maximise long-term value. First, BBC Worldwide has established jointly owned channels with the intention of contributing to building greater long-term value. These channels, in the UK and abroad, are intended to enable the BBC to exploit the full commercial potential of BBC programmes which have been shown first on the BBC's free-to-air channels. In the UK, BBC Worldwide joined forces with Flextech in October 1997 to launch the UKTV channels - UK Gold, UK Horizons, UK Style, UK Arena and UK Play. The BBC hopes that as digital television encourages more UK viewers to adopt multichannel TV, the UKTV channels will both enable greater access to the BBC archive and increase commercial returns for licence payers.

Second, internationally, BBC Worldwide has established joint venture operations with Discovery Communications Incorporated to develop global channels - Animal Planet and People and the Arts. The DCI deal also enabled BBC Worldwide to launch BBC America in March 1998 (the BBC's first wholly owned channel in the US, marketed and distributed by DCI).

The third step taken by the BBC to improve commercial exploitation of its assets was the incorporation last year of some of BBC Resources into a wholly owned subsidiary of the BBC called BBC Resources Ltd. The subsidiary is allowed to trade externally, whereas previously, Resources was only allowed to trade at the margin, ie to sell externally temporarily underutilised capacity. As a wholly-owned subsidiary, BBC Resources Ltd is now able to increase its non-BBC business, invest in new production technologies and aim for growth.

BBC Worldwide's Annual Report (1997/98) stated that the Company "will increase the rate of growth in the business through ever greater market focus and the development and exploitation of branded properties around the world, developing them across different media where the market demands it. At the same time, we will focus hard on improving efficiency of our business processes. The result, I [the then Chief Executive, Peter Teague] believe, will be a **quadrupling** of the cash that BBC Worldwide returns to the BBC by 2006." In order to deliver cashflow back to the BBC in excess of £200 million by 2006/07, BBC Worldwide will

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need to increase sales by 13% per annum to a level in excess of £1.2 billion, in addition to significantly improving profitability. BBC Resources Ltd is charged with providing an increased financial contribution and, like BBC Worldwide, a positive return to be invested in public service programmes. Its target is to generate an additional cash flow of £82 million over the next five years.

#### Concerns arising in evidence

Considerable concern has been expressed to the Panel about the BBC's commercial activities. A number of organisations, including the ITV Network, the Independent Television Commission, the British Internet Publisher's Alliance, United News and Media, BSkyB, the Radio Authority, the Producer's Alliance for Cinema and Television, the National Consumer Council, the Advertising Association and the Commercial Radio Companies Association, are concerned that the procedures introduced by the BBC for ensuring clear separation and transparency between its public and its commercial activities are inadequate. Some organisations, including the British Internet Publisher's Alliance, United News and Media, Teletext and the Producer's Alliance for Cinema and Television believe that the BBC's commercial activities are unfairly subsidised from the licence fee and that the BBC is not trading on fair terms.

On the other hand, there are those who believe that the BBC is not exploiting its assets sufficiently. In 1993, the National Heritage Select Committee (HC 1993-94, 77-1, para 96) urged the BBC to institute "a restructured system to support a more aggressive strategy for the sale of material, facilities, services and expertise at home and abroad". In its 1997/98 report, the Committee said it supported "the continued expansion of the BBC's commercial activities."

#### Panel view

The Panel fully supports the expansion of the BBC's commercial activities to generate additional income for UK public services. Such activities must not, however, detract from the BBC's core purpose as a public service broadcaster. It is possible to take two views on this issue. The first is that the slightest involvement in commercial activities will damage the integrity of a public service broadcaster. The second is that there need be no conflict between the two. Provided that the system of governance maintains the quality of programmes shown on the licence fee funded services, commercial exploitation of these activities can only benefit the BBC.

We believe that, under proper arrangements, it should be possible to increase commercial revenue significantly so providing extra money with which to enhance the quality of public service broadcasting. The BBC should pursue this aim more ambitiously than in the past.

## Restructuring of BBC Worldwide

The BBC should and could do more to exploit its assets and to generate more income from its programmes. But we believe that unless BBC Worldwide is restructured, the BBC will fail to take full advantage of the commercial opportunities available to it, both domestically and internationally.

At present, as we have seen, BBC Worldwide's portfolio of businesses can be split into two components:

- channels developed from the secondary use of BBC programmes, either in joint ventures with commercial partners or wholly owned by the BBC; and
- non-channel based activities such as programme sales, the exploitation of BBC books, videos and magazines and merchandising.

Channel based businesses	Non-channel businesses
BBC Prime	International programme sales
BBC World	Magazines (UK)
BBC America	Consumer publishing (UK)
Joint venture channels:	Overseas publishing
UKTV	New Media (CD Rom/online)
Flextech	
People and Arts } Animal Planet }	
Discovery	
UKTV (Australia)	
Pearson and FOXTEL	

We consider that there is potential for BBC Worldwide significantly to increase commercial revenues, but that its present structure is holding it back. In 1993, the Select Committee said the BBC needed to adopt a more "aggressive strategy", but BBC Worldwide's progress since then does not indicate that it has been sufficiently aggressive or entrepreneurial.

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#### Cash flow to the BBC from BBC Worldwide, 1994-95 to 1998-99

1994-95	1995-96	1996-97	1997-98	1998-99
£53 million	£60 million	£53 million	£75 million	£81 million

Growth has not been spectacular, though we recognise that the partnerships with Flextech and Discovery may greatly increase the BBC's commercial revenues and that the net benefit to the BBC might reach £200 million by 2006. However, we share the Select Committee's view that the growth potential could far exceed that figure.

So long as BBC Worldwide remains a wholly owned subsidiary of the BBC (it has no non-executive directors and the Chief Executive reports to the Director-General), it will not be able to compete as effectively as it could and should in the developing multi-media markets. This could be a real lost opportunity, particularly as the BBC has such a powerful media brand, which is recognised throughout the world for the quality and diversity of its programmes and the independence and accuracy of its news coverage.

As BBC Worldwide is organised now, it has distinct disadvantages. It does not depend for its survival on the exercise and reward of entrepreneurial skills, although some competitive stimulus is being provided by its increasing links with private sector partners. It has a necessary aversion to financial risk, because the licence fee cannot underwrite any losses by BBC Worldwide. It is also constrained by the Public Sector Borrowing Requirement and a lack of marketing expertise. We have also been told that its senior executives lack influence within the BBC. How, therefore, can such an organisation compete effectively in a market which is increasingly dominated by aggressive and very large enterprises? These multi-media groups have the advantages of commercial experience, economies of scale and synergies, and they are prepared to invest large sums in high risk ventures. Currently the BBC does not have the capital itself to develop major new markets, nor would it be desirable to use licence fee revenue for this purpose. However, an injection of private sector entrepreneurial skills and commercial expertise, and private sector finance at holding company level, could make a significant difference to BBC Worldwide's outlook and its performance and possibly bring complementary products to the BBC's services.

BBC Worldwide is currently involved in about 30-40 ventures with other partners and we estimate that the private value of these partnerships might be equivalent to a significant proportion of the total value of BBC Worldwide, perhaps as much as 20%. It can, therefore, be said that private funding is already contributing to the activities of the BBC. We would like to see a significant increase in the scale of private funding to reach a level of 49%. Over time, this could be done through additional joint ventures, but it would be preferable to do this more

rapidly through an injection of private capital at holding company level. This, plus the introduction of some external directors (which we see as essential), will bring more commercial expertise to the board of BBC Worldwide and access to private finance, while ensuring that the BBC keeps editorial control over its programmes in order to protect its brand name.

How such a sell-off is structured requires detailed work and professional advice. It may be that the sale of minority stakes to business investors is more appropriate than a stock market flotation. Furthermore, we accept that the joint-venture and branded channels may be best excluded from the sale. The joint-venture and BBC branded channels have been structured in a way that both insulates the BBC from all risk and guarantees a pay-back direct to current licence fee payers in return for the investment they are currently making in the programmes available for secondary exploitation. All risk or loss is carried by the joint venture partners.

We have not been able to get an accurate valuation of the suggested privatisation of a portion of BBC Worldwide's business. This can only be done after much detailed work. However, as an illustration, a 49% stake in the non-channel business of BBC Worldwide could be worth about £200 million. This represents the present value of the future net revenues of 49% of the relevant businesses.

After privatisation, the BBC will continue to receive the proceeds of sales of programmes to BBC Worldwide, as under the present arrangements, but will lose a share of future profits. This means that the short term loss of funds to the BBC will be very minor, amounting only to the share of profits owned in future by the private sector. This may be no more than a few million pounds per annum - a sum which could be quickly made up by the increase in the activities of BBC Worldwide which private involvement would bring about. If BBC Worldwide wishes to raise additional capital at the time of its sale it could do so; but the proceeds of the privatisation should accrue to the BBC.

We hope that the changed ownership of BBC Worldwide will enhance its future profitability. This should be reflected both in the sale price and in the future profit stream attributable to the BBC's remaining majority ownership.

### **BBC Resources**

We have seen that in August 1998 those parts of BBC Resources that were considered to have earning potential outside the BBC were incorporated into a new wholly owned subsidiary of the BBC, BBC Resources Ltd. The company was set a target of generating an additional cash flow of £82 million over the next five years. BBC Resources Ltd's Annual Report (1998/99) noted

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that although the company maintained its share of BBC Production's work during the period - and lost only a little of BBC Broadcast's - its external revenue was below forecast. On an eight month trading turnover of £223.3 million, the Company made an operating loss of £4.8 million, after charging £6.5 million against restructuring. The BBC's current expectations are that BBC Resources will move into profitability in the financial year 2000/01.

BBC Resources Ltd operates in a growing but very competitive UK broadcast facilities market which the BBC estimates at over £800 million. BBC Resources Ltd has also begun to operate in the wider market of multimedia, interactive, advertising, corporate and film making. BBC's research suggests that the market size could be some £1.5 billion and growing rapidly overall. On a global basis, the larger channel delivery market - broadcast communications, technical operations, channel branding etc - could be as great as £10 billion.

The question must be asked whether BBC Resources Ltd, as presently structured, is best placed to develop its commercial potential and capitalise on these opportunities. Incorporation meant that BBC Resources Ltd moved from being a public service organisation to a commercial one to enable the Company to trade beyond the margin, while being consistent with EU and UK competition law, State aid rules and BBC Charter constraints. These prevent the use of licence fee revenues to guarantee or cross-subsidise commercial activities. While necessary at present, the fair trading rules must be a major constraint in terms of developing commercial potential, for instance, the prohibition on cross subsidy between contracts or between business units.

Most of BBC Resources Ltd's business units are now in mature "commodity" industries (for instance conference facilities, outside broadcast units and television studios) and a market exists with a number of competitors that are likely to be interested and who have the ability to realise synergy and develop the commercial potential for BBC Resources Ltd. Moreover, the value of BBC Resources Ltd and the BBC's ability to realise that value should not be significantly constrained by sensitivities about brand control, as BBC Resources' Annual Report makes clear that the Company trades on the basis of its technical expertise. BBC Resources Ltd is unlikely to derive significant value from its association with the BBC brand. If sold, it would not, therefore, suffer from loss of the brand association. It would also be freed from fair trading constraints.

We see no strong reason for BBC Resources Ltd remaining a wholly owned subsidiary of the BBC and consider that steps should be taken to realise the value of the business for investment in improving the quality of BBC services. We recognise, however, that realising the value of Resources' assets will require detailed work, as the BBC's important craft base and therefore its creative capacity must not be undermined. And it is essential that any sale does not detract from the BBC's role as the UK's primary investor in core broadcast skills.

A 100% stake in BBC Resources Ltd could be worth in the region of £230 million.

### **The use of the proceeds**

We recommend the sale of a stake in BBC Worldwide and the bulk of BBC Resources Ltd primarily as a means of improving the profitability of their activities and their ability effectively to exploit BBC assets on behalf of the licence fee payer, while safeguarding the BBC ethos and observing the fair trading requirements. The proceeds of the sale could be of the order of £400 million and our recommendation is conditional on this being retained by the BBC, rather than remitted to the Exchequer.

As with any privatisation, these sales would replace a flow of revenue by a single capital payment. As mentioned earlier, we would hope that the enhanced profitability would produce a larger sum than the present value of the revenue flows under current payments (and the BBC would continue to benefit from its retained majority share of BBC Worldwide). However it would clearly be wrong to treat these capital receipts as if they were revenues available to finance current expenditure; the correct use would be to finance investment. The BBC has argued that it requires additional funding to develop the technology of digital programme-making. Much of this activity is in effect investment since it will provide continuing benefits to future viewers of digital television. (This activity is typically described as “investment” by those in the industry.) We therefore believe that it would be appropriate for the BBC to use the proceeds to finance it and we have included an allowance for these proceeds in our projections of the funds that will be available (under our proposals) to finance the BBC’s activities over the coming years. Any funds surplus to those needs could be held in a fund available to meet the Corporation’s future capital needs

### **Ensuring that there is an appropriate balance between the BBC’s public and commercial services**

As we said earlier, there need be no conflict between the BBC’s public and its commercial services. Provided that the system of governance maintains the quality of programmes shown on the licence fee funded services, commercial exploitation of these services can only benefit the BBC.

It is also important that the commercial services are clearly separated from the public services. However, although they should operate separately, there should be a common approach between them. The BBC’s long-term objectives and values as a public service broadcaster should underpin all its other activities. The BBC must, therefore, continue to adhere to the principles set out in its *Commercial Policy Guidelines*, including ensuring that BBC Worldwide’s aims are consistent with the objectives of the BBC, that revenues raised by BBC Worldwide are used to supplement income from the licence fee and that commercial returns are invested primarily in making new programmes to be shown first on free-to-air licence fee funded services.

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The BBC should continue to need the Secretary of State's approval before it establishes commercial subsidiaries or takes a stake in a private sector company. There should also be wide consultation with both the public and the broadcasting industry before such proposals are submitted to the Secretary of State.

As already noted, a particular problem arises with the launch of entirely new public services by the BBC in the UK market. These services will typically be free-to-air, and therefore do not directly impact on the BBC's commercial revenues. Nevertheless, precisely because they are free-to-air, they are often seen as grossly unfair competition by private broadcasters. Indeed, the launch of such services by the BBC can call into question the economic viability of similar services which have already been launched by the private sector. The risk that this may happen could be a disincentive to the future development of private sector broadcasting services.

There is at present one safeguard against the BBC abusing its privilege to launch free-to-air services at public expense. The Secretary of State for Culture, Media and Sport is required to grant permission to the BBC to launch such services, and these decisions can subsequently be challenged in the courts. We are assured that these decisions are not taken lightly, and that careful criteria are followed before the Secretary of State forms a view in each individual case. However, we believe that this process, like so many others discussed in this Chapter, can be improved and made more transparent. We have three proposals to make.

- First, we would suggest that each application for a new public service approval by the BBC should be published in full, and that adequate time for a comprehensive public debate should be allowed before the Secretary of State reaches a decision. In some cases, it may be that the private sector might be able to argue persuasively that the market is already able to provide such a service, making duplication by the BBC unnecessary.
- Second, we suggest that the criteria used by the Secretary of State in reaching such decisions should also be published in full, and that the eventual decision should be justified in detail to the public.
- Third, we suggest that at the time of the Charter Review, a comprehensive review should take place of the services recently launched by the BBC, in order to decide whether such services continue to fulfil public service criteria. If they do not, they should be closed.

Indeed, the BBC should continue to specify, clearly and critically, in its Annual Report, how it has fulfilled its public service obligations (as set out in the Charter and Agreement), for all its established services (radio and television). This will enable licence fee payers better to judge whether the BBC's public service purposes are being maintained, as well as, more generally, whether they are receiving value for money from the licence fee.

In the longer term, when the Charter is reviewed, consideration should be given to providing a tighter definition of the BBC's public service obligations (see Chapter 5). In particular, we consider that the BBC's public purposes should be specified in terms which can readily be translated into performance criteria for assessment under whatever regulatory arrangements apply post-Charter review.

Finally, it is essential to ensure that there is no risk to public funds by a clear organisational and accounting separation between the BBC and its commercial subsidiaries and by greater transparency of accounting arrangements. We return to this below.

**In summary, the Panel\* recommends that:**

- *the BBC should sell a stake in BBC Worldwide sufficient to take the effective private involvement in its total external operations to 49%, with the objective of better exploiting its assets and increasing the return to the licence fee payer;*
- *the BBC should sell the bulk of BBC Resources Ltd;*
- *proposals for new BBC public services should be published and debated in full, along with the criteria used by the Secretary of State in deciding whether to permit the launch of such services;*
- *the Charter Review should consider whether new BBC services continue to fulfil a public service remit;*
- *the BBC should demonstrate annually, in its Annual Report, for **each** of its established services, that it is continuing to fulfil its public service obligations;*
- *the BBC should ensure that BBC Worldwide's aims are consistent with the objectives of the BBC and that the BBC makes programmes, formats and rights available to BBC Worldwide at market prices; and that*
- *there should be a clear organisational and accounting separation between the BBC and its commercial subsidiaries and that there should greater transparency in the BBC's accounting arrangements.*

\* One of the Panel's members, Helen Black, is unable to support the recommendations to sell a 49% stake in BBC Worldwide Ltd and to privatise BBC Resources Ltd. In the case of the former, Helen considers that unsustainable tensions would arise between the private shareholders' desire for maximum profits on the one hand and, on the other, the licence fee payers interests, and the Governors' need to ensure fair trading, the protection of standards and the integrity of the BBC brand. On the latter, Helen considers that it would lead to the BBC becoming a publisher - broadcaster only, because privatisation would erode the craft and skills base within the BBC, and that ultimately the BBC would end up paying more for programmes than it currently does. Furthermore, Helen does not consider these recommendations to be the best way to maximise net income to the BBC in the longer term.

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### Regulation of the BBC's fair-trading commitment

As already mentioned we regard the question of balance between the BBC's public service and commercial activities as directly related to the question of governance.

#### Current arrangements

The structure and operation of the BBC's commercial services are designed to ensure that they:

- are operated and funded separately from public services;
- compete fairly in the markets in which they operate; and
- are subject to scrutiny to at least the same level as other UK companies.

Currently, the BBC aims to achieve this in six ways:

#### i. separate commercial subsidiaries

Trading between BBC Worldwide and BBC Resources Ltd and the rest of the BBC is carried out at arm's length, without recourse to public funds.

#### ii. published annual reports

Both BBC Worldwide and BBC Resources Ltd publish annual reports and accounts to plc standard levels of disclosure.

#### iii. OFT scrutiny

The BBC's commercial activities are subject to domestic (and European) competition law.

#### iv. Fair Trading Commitment and Commercial Policy Guidelines

The *Fair Trading Commitment* (required under the Royal Charter and Agreement) sets out the trading standards the BBC will maintain for its commercial activities, focusing on three principles:

- clear criteria for commercial activities;
- fair competition;
- no use of, or risk to, public funds.

In addition, the BBC publishes *Commercial Policy Guidelines*, which set out how BBC subsidiaries and departments should operate their commercial activities in order to comply with the terms of the *Fair Trading Commitment*.

v. **Governors' Fair Trading Audit Committee**

We understand the Committee meets regularly throughout the year to monitor compliance with the *Fair Trading Commitment* and with the statutory fair trading requirements and that it receives reports directly, and without the intervention of management, from the BBC's Chief Adviser, Commercial Policy; from the Head of Internal Audit and from a firm of external auditors, currently KPMG. The BBC's *Annual Report and Accounts* includes a statement from the Committee.

vi. **External audit**

KPMG is charged with reviewing the operation of the BBC's commercial activities during each financial year and, specifically, giving a formal opinion on compliance with the *Fair Trading Commitment*. KPMG publishes a free-standing formal opinion in the BBC's *Annual Report and Accounts*.

Despite the BBC's efforts to put in place procedures intended to achieve transparency and separation of public service and commercial operations, these procedures have not yet inspired public confidence. Whilst hard evidence that the BBC is trading unfairly has not come to light, many organisations have expressed their concerns to the panel. For instance, the British Internet Publishers' Alliance is concerned about the channelling of audiences from the public internet service, BBC Online, to the commercial service, beeb.com, through hypertext links and other cross-subsidies and promotions. The Alliance argues that these elements drain potential viewing from competitors and adversely affect the potential advertising and sponsorship revenues that might be earned by private sector operators. United News and Media and Teletext are similarly concerned about what they describe as the BBC's use of licence fee funded services to promote its commercial internet service.

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The Producers Alliance for Cinema and Television is concerned about the BBC selling the programmes it controls cheaply to its own commercial channels and securing programmes without competition for BBC Worldwide. The Image Industry Alliance expressed concern about anti-competitive behaviour by BBC Resources Ltd. The Alliance claims that in an essentially fixed cost business, BBC Resources Ltd's ability to "marginal price" additional work because BBC contracts underpin the business, is a serious threat to the sector, especially when that goes with the spare capacity that exists in various BBC facilities. The Commercial Radio Companies Association and Capital Radio expressed concern about the extent and cost of cross-promotion of BBC services.

Clearly there is considerable concern that the BBC is not sufficiently transparent about how it spends the licence fee and that the procedures for ensuring clear separation and transparency between public and commercial services are inadequate. ITV sees the fundamental problem as being that the Governors - who are ultimately responsible for monitoring the separation between the BBC's public service and commercial operations - do not have their own secretariat; they are advised by BBC staff. Until there is a greater degree of distance between those who oversee the BBC's adherence to its remit, and the staff of the BBC, ITV believes there will be continuing doubts as to its transparency. As an example, ITV questions the validity - without external scrutiny - of the BBC's internal market testing procedures in the Rights Agency of the programmes it sells to BBC Worldwide. Since BBC Worldwide effectively has the right of first refusal on a majority of BBC programmes, and the BBC's Rights Agency only sporadically market tests the price of programmes, ITV says it is unclear how the Rights Agency knows that it is receiving a proper market price. Hence there will be lingering suspicions about cross-subsidy which would only be properly addressed by greater external regulatory scrutiny, and/or by making the programmes available on the open market so that competitors could bid alongside BBC Worldwide.

The solution proposed by ITV and the Independent Television Commission among others is for independent regulatory scrutiny of the fair trading commitment to ensure that there is no cross-subsidisation of the BBC's commercial activities by the licence fee taking place.

The BBC points out that it is subject to the full force of domestic and European competition law, in exactly the same way as any other British company but that, because of its special position as a publicly funded organisation, it has embraced the further arrangements outlined earlier in this Chapter. The BBC also points out that it has an excellent record of trading fairly, with not a single complaint upheld by the Office of Fair Trading since it adopted the *Fair Trading Commitment* and published the *Commercial Policy Guidelines* in 1995. The BBC considers that the regulatory regime to which its commercial activities are subject has a proven record of being effective, and that disclosure and external scrutiny goes beyond that of any other UK media company.

### Panel's view

It is essential that the BBC's commercial activities are conducted in ways that are fair to its competitors. This means that they must not be subsidised by the licence fee or the grant-in-aid which finances the World Service. The Panel acknowledges that the BBC has gone to some length with its arrangements on fair trading, but is not convinced that these are wholly adequate. The licence fee is to all intents and purposes public funding and, as such, not only must the arrangements be effective, they must be seen to be effective. Otherwise they will fail to inspire public confidence. We do not believe that this is possible without some form of external scrutiny. Moreover, we consider that the need for this will become ever more important as the BBC expands its commercial enterprises in the coming years. The role of the Board of Governors is outside our remit, though the governance of the BBC, in particular the sustainability of self-regulation generally, will clearly be an issue at Charter renewal. However, we believe that some steps should be taken both in the short term and on a slightly longer time-scale, to provide the necessary assurance that the BBC's accounts are sufficiently transparent and that the Corporation's fair trading commitment is adequate.

### Recommendations

As a first step, we recommend that the Office of Fair Trading carries out, within the next twelve months, a paper exercise to consider the adequacy of the relevant BBC documentation: *Fair Trading Commitment* and the *Commercial Policy Guidelines*. We do not consider it is necessary to recommend an ongoing monitoring role for the Office of Fair Trading, largely because of the strengthened powers given to the Office of Fair Trading in the Competition Act 1998 (which comes into full effect in March 2000). The legislation will prohibit anti-competitive agreements that do not meet the criteria for exemption, and will also prohibit abuses of dominant position (for which no exemptions are available). Moreover, section 2 of the Fair Trading Act 1973 (which will remain in force) requires the Director-General of Fair Trading, so far as appears to him practicable, to keep under review commercial activities in the UK, looking for, among other things, monopoly situations and uncompetitive practices. When he finds them, he may take action under the powers given to him by Part IV of the Fair Trading Act (which empowers him to make monopoly references to the Competition Commission).

### Chapter 3 - Achieving a Level Playing Field

We believe that greater transparency would help to give the public greater confidence in the existing arrangements and recommend that, within the next twelve months, the National Audit Office, carries out two separate reviews of the BBC's accounts and processes. One of these should concentrate on how the BBC ensures compliance with fair trading policy (external and internal). The other should examine the transparency of the BBC's financial reporting culminating in its *Annual Report and Accounts*.

We also make a further recommendation involving the National Audit Office, necessitating an amendment to the Royal Charter, in the final Chapter

We recommend that the BBC, in consultation with the Secretary of State, appoints a commercial audit firm for trading purposes which is separate from that which carries out the Corporation's financial audit. Currently, the same firm of external auditors carries out both the annual financial audit and also the audit of the fair trading commitment. A separate commercial audit firm for fair trading purposes should therefore ensure that any issue of conflict of interest does not arise. We also recommend that the separate auditors' **full** report on compliance and risk is published by the Governors as part of the Annual Report.

Finally, we recommend that the BBC publishes a quarterly complaints bulletin on fair trading and transparency issues, as it currently does for programme complaints.

#### **In summary, the Panel recommends that:**

- *the Government should request the Office of Fair Trading to review, within the next twelve months, the adequacy of the BBC's documents: Fair Trading Commitment and the Commercial Policy Guidelines;*
- *the Government should request the National Audit Office to carry out, within the next twelve months, two separate reviews of the BBC's accounts process:*
  - *The first should concentrate on how the BBC ensures compliance with fair trading policy, both internal and external; and*
  - *the second should examine the transparency of the BBC's financial reporting culminating in the BBC's Annual Report and Accounts;*
- *the BBC, in consultation with the Secretary of State, should appoint a separate commercial audit firm for fair trading purposes from that which carries out the BBC's financial audit and that the audit firm's full report on compliance and risk should be published by the BBC; and that*
- *the BBC should publish a quarterly complaints bulletin on fair trading and transparency issues.*

