



European Commission

Review of the Communication from the Commission on the Application of State Aid Rules to Public Service Broadcasting

Submission by the Satellite and Cable Broadcasters' Group

10 March 2008

The SCBG is the trade association for satellite and cable programme providers who are independent of one of the main terrestrial broadcasters. Its members are responsible for over 100 channels in the UK and in addition broadcast many more services from the UK to continental Europe and beyond. Many member companies are pan-European broadcasters, producing and commissioning content for different national markets.

SCBG channels provide citizens and consumers with programmes and services for a diverse range of audiences across a wide range of genres and audiences, including entertainment, factual, educational, history, music, nature, art and science. Our member companies make and show programmes for children and young people, and for ethnic minorities in their own languages. SCBG members' channels are available in almost 50% of UK homes.

Satellite and cable broadcasters operate in an extremely competitive and volatile environment, without privileged access to scarce Government-controlled spectrum or to the must-carry status afforded to terrestrial networks. They are therefore unable to attract mass advertising revenues, and – with a couple of notable exceptions – do not benefit from public funding.

Satellite and cable broadcasting has been the fastest growing sector in the UK television industry, now employing over 6,000 people in the UK with revenues of nearly £5 billion.

Executive Summary

Here are the main elements in our submission:

- The SCBG believes that the time is right for an updating of the Communication. Not only is there impending regulatory reform as a result of the Audiovisual Media Services Directive, which needs to be accommodated in the Communication, but the media and communications sectors are experiencing considerable commercial and technological change as a result of consumer switching to digital platforms.
- As PSBs embrace the provision of thematic services, clarity on issues such as market failure and market impact become even more critical to commercial business models.
- Where PSBs do pursue commercial activity, the Communication should provide guidance not only on transfer pricing and cost allocation, but on issues such as licensing practices (including compliance with non-discrimination obligations) and on the need to ensure effective functional separation of public services from commercial activities.
- Member States should be required to consult with all stakeholders over the likely range of costs of providing defined public service activities in advance of agreeing the funding requirement for the PSBs, including the value of non-monetary benefits.
- Clarity in the scope of the PSBs activities (both commercial and public service) plays a critical role in the investment decisions of the broadcasters who have to compete with them.
- The Communication should explain what is meant by the term market failure and should offer clear guidelines as to how Member States should test for market failure.
- We believe that an ex ante evaluation for new media activities should be incorporated into a revised Communication.
- Supervision of PSBs should be undertaken through an independent and well resourced regulator
- We believe that functional separation of the BBC's commercial activities from its parent organisation (including an end to BBC Worldwide's preferred partner status) would be a useful step towards the elimination of sufficient conditions for cross-subsidy, would provide for a more effective means of regulating the relationships between the BBC and its commercial activities and would allow the BBC Trust to allocate its regulatory resources to other aspects of the BBC's activities.
- We would support the inclusion of a requirement for Member States to clearly set out the parameters for determining levels of compensation. In particular, we would ask that the Communication provides guidelines to Member States on how to prevent over-compensation as a result of foregone revenue.
- The Communication should require, as a minimum, that Member States impose obligations on their PSBs to avoid pricing below market rates. In support of this requirement, the Communication should offer guidance on how to ensure that a market price is paid.

Detailed Response to Questionnaire

1. GENERAL

1.1. *A number of significant legal developments have taken place in the public broadcasting area since 2001, namely the adoption of the Audiovisual Media Services Directive, the adoption of the Decision and Framework on compensation payments as well as Commission decision-making practice. Do you think that the Broadcasting Communication should be updated in light of these developments? Alternatively, do you consider that these developments do not justify the adoption of a new text?*

The SCBG believes that the time is right for an updating of the Communication. Not only is there impending regulatory reform as a result of the Audiovisual Media Services Directive, which needs to be accommodated in the Communication, but the media and communications sectors are experiencing considerable commercial and technological change as a result of consumer switching to digital platforms. Whilst we recognise the important role to be played by the public service broadcasters (PSBs) during the transitional period, the regulatory framework surrounding the activities and funding of the PSBs must reflect the ability of the PSBs to distort competition and undermine commercial business models. This is particularly important in the new media and thematic channel sectors where the markets are still at a nascent stage in their development. In particular, current uncertainties in commercial broadcasting economics, as a result of increased competition and digitalisation, magnify the potential competitive harm, which can arise from PSBs' activities. It is therefore more important today that it was in 2001 to ensure effective guidelines for Member States' decisions on both the scope and funding of PSBs in Europe. Further, as PSBs are presented with increased opportunities to raise revenue from commercial exploitation of their publicly funded assets, for instance as a result of licensing content for commercial exploitation in secondary markets by either new entrants or their own, care needs to be taken both to ensure that appropriate measures are taken to account for these potential revenues in the preparation of compensation out of public funds. Not only would the efficient pursuit of commercial revenues in this way be more economically efficient than reliance on tax payers the non-discriminatory licensing of publicly funded content could support innovation in the new media space, where the cost of acquiring high quality content is a commonly cited entry barrier.

1.2. *How would you describe the current competitive situation of the various players in the audiovisual media sector? Where available, please provide the relevant data on for instance leading players, market shares, market share evolution in the broadcasting/advertising/other relevant markets.*

The Commission should refer to Ofcom's Communications Market 2007 report for a detailed statistical analysis of the UK television market.¹

1.3. *In your view, what are the likely developments and where do you see the major challenges for the sector in the future? Do you consider that the current rules will remain valid in the light of the developments or do you believe that adaptations will be necessary?*

¹ <http://www.ofcom.org.uk/research/cm/cmr07/>

Consumers switching to digital platforms has increased audience fragmentation, increasing pressures on advertising revenues and forcing commercial broadcasters to develop more innovative services, such as online and mobile video, and to diversify their content propositions. Another consequence of digitalisation is the market's move increasingly towards thematic services, with PSBs, such as the BBC and Channel 4, following the market trend. As PSBs embrace the provision of thematic services, clarity on issues such as market failure and market impact become even more critical to commercial business models. The ability of the PSBs to cross-promote their thematic services from their long standing generalist TV channels create a significant competitive threat to commercial channels, who may not have the benefits of a universally available terrestrial channel to use for this purpose. Consumer switching to thematic services raises further issues for the governance of the PSBs. For instance, it is rare for a PSB to enter a thematic genre where there is not already market provision. This raises questions as to whether there genuinely is a market failure and the extent to which the PSBs' market entry forecloses this genre to further entry and investment by commercial operators.

As the sector experiences greater horizontal and vertical convergence it becomes increasingly difficult to prove that there exists a market failure within any particular genre. With digital platforms offering several hundred linear channels (both general and thematic) as well as on-demand services, the regulatory framework must evolve to reflect that the market is now providing far more of the sorts of content traditionally associated with PSBs, such as education, documentaries, the arts, news and childrens programming. Indeed, it is increasingly difficult to identify genres where genuine market failure still persists. As the media sectors are increasingly fast moving, more regular review of services provided by PSBs, in particular to determine the extent to which the market has the potential to provide the services in question, would be welcomed. In addition, approvals for new public services should contain sunset clauses, marking an appropriate time for a market review.

As PSBs continue to extend their services into the digital environment their means of funding is increasingly subject to pressure. As a result, we expect that PSBs will increasingly press for increased public funding as well as consent to develop further their commercial activities. It is our view that the revised Communication should focus more heavily than the current text on the PSBs' commercial activities, including their regulation and scope. We do welcome an increased focus on commercial activities by the PSBs, but believe they raise issues for the regulatory framework, which were not considered relevant in the drafting of the 2001 Communication. Where PSBs do pursue commercial activity, the Communication should provide guidance not only on transfer pricing and cost allocation, but on issues such as licensing practices (including compliance with non-discrimination obligations) and on the need to ensure effective functional separation of public services from commercial activities. In particular, where PSBs are reliant on mixed revenues the Communication should offer guidelines on how Member States should test for forgone commercial revenues and the efficiency of the PSBs' commercial activities before agreeing to any increase in public funding. Indeed, where it can be shown that the PSB is behaving inefficiently with regards the generation of commercial income it should be expected that public funding be reduced as a means of incentivising efficiency.

2. COMPATIBILITY ASSESSMENT UNDER ARTICLE 86 (2) EC TREATY, IN COMBINATION WITH THE BROADCASTING COMMUNICATION

2.1. Coherence with the Commission Decision and Framework on public service compensation

2.1.1 Do you consider that (at least some of) the requirements laid down in the Decision and Framework on public service compensation should be included in the revised Broadcasting Communication or not? Please explain why.

We believe that the requirement of the Decision and Framework should be included in the revised Communication. The Decision and Framework contains well-considered and helpful guidance on issues such as cost recovery, over-compensation and reasonable profit, which are all highly relevant to the regulation of PSBs.

2.1.2 In the affirmative, please specify which requirements should be included and explain what adaptations, if any, would be appropriate for the broadcasting sector (see also the questions below, in particular those on overcompensation; point 2.6).

Member States should be required to consult with all stakeholders over the likely range of costs of providing defined public service activities in advance of agreeing the funding requirement for the PSBs. To this extent, the text on the amount of compensation is helpful. However, the Communication should make it clear that Member States must clarify the value of non-monetary benefits, such as preferential listing on Electronic Programme Guides, must carry provisions and gifted capacity on relevant distribution platforms. In particular, the guidance offered on the cost recovery for non-public service activities should be included. With regards the issue of compensation it is important to incorporate profits from efficient commercial activities in any financing settlement. Further, where it can be shown that a PSB is not efficiently exploiting its publicly funded assets, through whatever means, to generate commercial revenues the Communication should explain why this amounts to over-compensation of the PSB and require that Member States take appropriate measures to increase efficiency and to reduce over-compensation. The Decision and Framework text on over-compensation should be amended to reflect the risk of over-compensation as a result of inefficiency in the PSBs' commercial activities.

2.2. Definition of the public service remit

2.2.1. You are invited to provide information on the definition of the public service remit in your country, in particular as regards new media activities.

NA

2.2.2. Do you consider that the distinction between public service and other activities should be further clarified? In the affirmative, which measures could provide such clarification (e.g. establishment by the Member State of an illustrative list of commercial activities not covered by the public service remit)?

We believe that the distinction between public service and commercial activities becomes increasingly crucial as PSBs are faced with increased pressure to generate commercial revenues. Clarity in the scope of the PSBs activities (both commercial and public service) plays a critical role in the investment decisions of the broadcasters who have to compete with them. A white list of commercial activities would not be appropriate as it would never be a static list. A regular review of a PSBs' activities should be required to determine whether particular services continue to satisfy an identifiable market failure. Where a service no longer satisfies a market failure, the activity should then be considered to be no

longer a public service. As market failures will differ between Member States and across time within Member States a static list of commercial activities would not be appropriate.

Rather, clarity should be provided with regards the process for determining whether a particular service constitutes a public service or a commercial activity. This clarity should be provided in the Communication. For example, the Communication should explain what is meant by the term market failure and should offer clear guidelines as to how Member States should test for market failure. The current approach in the UK, with regards proposed new BBC services, is based around the concept of testing for public value. Whilst this approach has its advantages, it fails to examine whether the proposed service is remedying a market failure. The approach is based upon a presumption that a market failure exists. We would welcome an explicit requirement for Member States to prove that a market failure exists, as a minimum, before consenting to the funding (either continued or new) of a proposed (or existing) service.

2.2.3. In the current Broadcasting Communication, activities other than TV programmes in the traditional sense can be part of the public service remit provided that they serve the same democratic, social and cultural needs of society. Does this provision sufficiently clarify the permissible scope of such public service activities? Why? In the negative, do you consider that further clarifications should be provided in a revised Broadcasting Communication?

As PSBs seek to move beyond their traditional linear TV channels additional clarity is required as to how Member States are to determine whether a proposed service constitutes a public service. As PSBs seek to introduce thematic TV services or Internet based services care is necessary as it is more likely that the market is equipped to provide such services without the need for public intervention. In the Internet sector, in particular, entry barriers for new content service providers are much lower than is the case in traditional markets, increasing the scope for commercial entry and reducing the probability that there exists persistent market failure. As consumers are empowered with increasingly easy to use search engines and content providers are able to aggregate consumers from across Europe and the rest of the world, it is increasingly less likely that there will exist persistent market failure in the Internet sector. As testing for market failure in new and developing markets is more challenging that is the case in traditional markets, guidelines from the Commission would ensure consistency of approach across the EU and provide much needed clarity for both PSBs and commercial operators.

In addition, the scale and financial weight of a PSB entering into these nascent markets can undermine the development of the market before new commercial models are able to sufficiently establish themselves. As such, even the expectation of entry by a PSB can be sufficient to act as a barrier to entry by smaller potential entrants. As innovation in the Internet economy has tended to be driven by small new entrants, rather than by established media players, even the threat of entry by a well funded PSB can undermine both economic and consumer welfare. The rapid pace of development in the new media environment also requires that Member States should more regularly review the funding of approved public services. Where it can no longer be proven that a market failure is persistent then a public service should be withdrawn.

2.2.4. Do you consider that the general approach in the recent decision-making practice of the Commission (i.e. determination of the public service remit based on an ex ante evaluation for new media activities) could be incorporated into a revised Broadcasting Communication?

We believe that an ex ante evaluation for new media activities should be incorporated into a revised Communication.

2.2.5. Should a revised Broadcasting Communication further clarify the scope of an ex ante evaluation of the public service remit by Member States?

Yes. Increased clarity on the scope of an ex ante assessment would aid consistency of approach across the EU and increase certainty for commercial players, thereby creating necessary conditions for investment and market-driven innovation.

2.2.6. Which services or categories of services should in your view be subject to an ex ante evaluation?

For consistency all proposed new public services should be subject to ex ante evaluation. As a minimum, for reasons set out above, proposed new media and thematic services should be subject to a rigorous ex ante evaluation.

2.2.7. Should a revised Broadcasting Communication contain the basic principles as regards the procedural and substantive aspects of such an evaluation (such as for instance the involvement of third parties or the possible evaluation criteria, including for instance the contribution to clearly identified objectives, citizen needs, available offers on the market, additional costs, impact on competition)?

The provision of details on the basic principles that such an evaluation should incorporate would provide much needed clarity and consistency of approach.

2.2.8. In view of the fact that the determination of the public service character of such activities may be determined in various ways, to what extent should a revised Broadcasting Communication set out possible different options?

The Communication should focus on the economic and market impact aspects of the evaluation, where a consistent approach and methodology is both feasible and desirable. Social and political aspects of any evaluation should remain the responsibility of each Member State, given the different social requirements of each Member State, subject to transparency and proportionality.

2.3. Entrustment and Supervision

2.3.1. You are invited to explain in which way entrustment is granted in your country. Is the procedure leading to the entrustment subject to public consultation? To what extent is the broadcaster's remit laid down in legally binding acts of entrustment? To what extent is the implementation and determination of the exact scope of activities left to public service broadcasters? Are any such "implementing measures" publicly available?

NA

2.3.2. Please explain the mechanisms to supervise public service broadcasters in your country. What is your experience of the existing supervision mechanisms? Do you consider that there are sufficient possibilities for third parties to take action against alleged infringements/non-fulfilment of public service (and other) obligations in your country?

The UK's primary PSB, the BBC, is subject to regulation by the BBC Trust, whilst the commercial PSBs (ITV, Channel 4 and Channel 5) are subject to licensing and regulation by Ofcom.

Whilst Ofcom is a well-resourced and respected independent regulator, there are concerns that the BBC Trust is not sufficiently resourced with regulatory specialists (i.e. economists and lawyers) to undertake its required tasks to the necessary standards. Recent experience of handing a consultation on the regulation of the BBC's commercial activities suggests that the BBC Trust is not sufficiently abreast of current best practice in regulation of vertically related firms. For instance, when it was suggested that there was insufficient functional separation of the BBC's public service and commercial activities to ensure compliance with the BBC's non-discrimination obligation, their response was that transfer pricing was sufficient to address both price-based and non-price discrimination concerns. This is contrary to the positions taken by economists and by other regulators faced with similar situations.

Moreover, in the area of Fair Trading the BBC Trust serves as an appeals panel rather than a regulator, with regulatory complaints being initially considered by the BBC's management. The process, agreed bilaterally between the BBC and the BBC Trust is such that a complainant is directed to the BBC before the BBC Trust will consider the issue only on appeal. This is a rather cumbersome process and lengthens the time take to reach resolution. In particular, complainants have little reason to believe that a complaint about the BBC's behaviour will receive a balanced consideration when the complaint is heard by the BBC management themselves. A process whereby complaints could be made directly to the BBC Trust would create greater confidence in the regulatory framework. That the scope of the BBC Trust has been made subject to agreement with the BBC would suggest a lack of independence.

2.3.3. Do you consider that the Broadcasting Communication should contain further clarifications about the circumstances in which an additional act of entrustment (i.e. in addition to the general provisions laid down by law) is necessary or are the current rules sufficient?

[No comment]

2.3.4. Do you consider that the Broadcasting Communication should contain further clarifications in order to ensure increased effectiveness of supervision of public service broadcasters? What are in your view the advantages or possible drawbacks of control authorities independent from the entrusted undertaking (as referred to in the Broadcasting Communication) as opposed to other control mechanisms? Do you consider that effective supervision needs to include sanctioning mechanisms, and if so, which ones?

As is the case with the regulation of the UK's commercial PSBs (ITV, Channel 4 and Channel 5), supervision should be undertaken through an independent and well resourced regulator, such as Ofcom. Regulatory capture, both by politicians and by the PSB is a fact of life in this sector and every possible measure must be taken to safeguard against this. Whilst independent regulation cannot guarantee that there can never be regulatory capture, it does make capture easier to detect and to correct. Whilst it may be politically difficult to impose monetary sanctions on a PSB, there are other sanctions that may be appropriate, such as restrictions on new services or an independent review of an existing service, with a view to closure if no persistent market failure is present. This should not preclude

financial sanctions on commercial activities undertaken by a PSB. The Commission may consider that social pressure on the management of a PSB, as a result of the risk of a financial penalty and consequent decline in service quality, is both an effective measure and proportionate given the potential market distortions that a well funded PSB can cause. Indeed, failure to apply financial sanctions provides a PSBs' activities with an unfair advantage over rival commercial operators, who face the risk of financial penalties as a cost of operating. The lack of an effective penalty mechanism reduces the incentives of the PSBs' activities to comply with relevant regulatory obligations.

2.3.5. Should there be specific complaints procedures at national level where private operators could raise issues related to the scope of the public service broadcasters' activities? If so, what form should they take?

Commercial operators must have scope to raise concerns about the scope of a PSBs' activities (both public service and commercial) to a properly resourced and demonstrably independent regulator. The regulator must not be dependent upon the direct financial support of the PSB, although both may be funded out of the same monies. Moreover, the regulator must be legally and operationally separate. In particular, management of the PSB should enjoy the same levels of access to the regulator as enjoyed by commercial operators. This includes a requirement for transparency of operation where a complaint has been made and the right of a complainant to access the same meetings and the same evidence/resources as is made available by the regulator to the PSB.

2.4. Dual Funding of public service broadcasters

2.4.1. What is – in your view - the expected impact of (partly) State-funded pay services on competition?

The introduction of pay services by PSBs raises some fundamental issues. Firstly, if it can be shown that consumers are willing to pay for a service, where is the market failure? Should it not be expected that the market will develop to satisfy the consumers' demand? Where a service is partly state funded then there is a question of how to determine the appropriate level of compensation. In terms of impact on commercial operators, the entry into the pay TV market by PSBs would constitute a direct competitive threat to commercial revenues. Moreover, given the state funding of the service, the PSB faces a clear incentive to set the retail price below the market level to attract consumers (in order to justify the continued state funding). Difficulties in determining exactly what would constitute a correct market price and asymmetries between the PSBs and its regulator would make it impossible for any regulator to credibly ensure that there was no anti-competitive pricing. New entrants, who do not have necessary scale to attract sufficient advertising revenues to support nascent business models would be likely to be most significantly impacted. These operators may view pay/subscription revenues as a vital source of income as they build their brand awareness and audience to a stage where they can attract multiple revenue sources. The threat of entry by well resourced PSBs, with their cross-promotional abilities, into the market for pay services not only risks squeezing the revenues of existing pay service providers, but would serve to raise yet another entry barrier to commercial operators.

The impact on the incentives of the PSBs themselves should not be ignored. A service which is dependent upon pay revenues will tend to focus more heavily on ratings and

willingness to pay than on raising social benefit. Not only will this tend to undermine commercial operators, it will also call into question the entire rationale for PSBs.

2.4.2. Should pay-services always be considered as purely commercial activities or are there instances in which they could be regarded as part of the public service remit? For instance, do you consider that pay-services as part of the public service remit should in this respect be limited to services which are not offered on the market? Or do you think that pay-services could be regarded as part of the public service remit under certain conditions? In the affirmative, please specify which. For instance, should the conditions include elements such as specific public service objectives, specific citizen needs, existence of other similar offers on the market, inadequacy of existing public service obligations or inadequacy of existing funding to meet particular citizen needs?

For the avoidance of doubt, pay services should be considered to be commercial activities, rather than public services. To allow this principle to be breached would be the start of a slippery slope towards PSBs facing increased incentives (financial pressure) to pursue ratings and commercial success, at the expense of their public service objectives. It would be difficult to restrict pay services offered by PSBs to those areas not supplied by the market. Given the low entry barriers on the Internet, how would it be determined that the market could not provide a relevant alternative to the service being proposed by the PSB?

2.5. Transparency requirements

2.5.1. To what extent are commercial activities carried out by the public service broadcaster itself in your country? Is there a structural or functional separation between public service and commercial activities?

The UK's PSBs (BBC, ITV, Channel 4 and Channel 5) all operate both public service and commercial activities. With regards the BBC, its commercial activities are typically undertaken by wholly owned subsidiaries, although the BBC's public service divisions do undertake limited commercial activity using spare capacity. The BBC operates a system of accounting separation, but there is no functional separation in place. It should be noted that the BBC operates a system whereby its primary commercial subsidiary, BBC Worldwide, benefits from an exclusive preferred partner relationship. BBC Worldwide enjoys an exclusive first look at commercial exploitation rights in publicly funded BBC intellectual property. It may also benefit from matching rights and other advantages, either formally or informally as a result of its close operational relationship. Further, the CEO of BBC Worldwide sits on the Executive Board of the BBC. At an operational level, the close relationship and preferred partner status means that BBC Worldwide staff have discriminatory access to the BBC's public service staff (including through shared facilities and cross-BBC career progression), to meetings and to information on the BBC's public service activities, including new product development and commissioning. There is also no effective operational or functional separation between the BBC's public service news gathering functions and BBC World, the BBC's international commercial news channel.

2.5.2. Do you consider that there is a need for a structural or functional separation of commercial activities, and if so why? What would the positive or negative effects of either a structural or a functional separation?

The BBC's practice of discriminating in favour of BBC Worldwide, through its use of a preferred partner relationship undermines the regulatory benefit of any accounting separation employed by the BBC.

The lack of effective functional separation increases the probability of discrimination. There is a considerable literature on the ability and incentives of a vertically integrated player to engage in non-price discrimination.² The literature explains how, by discriminating in favour of its downstream activity, a vertically integrated player is able to capture a larger share of downstream profits. Although the details of each of the papers referred to differs there is a common theme which suggests that non-price discrimination should be a matter of regulatory concern (Cave et al, 2006). Concern is particularly acute where there is tight regulation on the upstream operation and where the upstream operator has market power. Non-price discrimination is attractive in these conditions because price-based regulation limits the ability of the vertically integrated operator to fully exploit any market power that it has.

Where the ex ante prohibition on cross-subsidy is not fully effective, then the upstream operator faces a choice of price-based or non-price discrimination depending on the nature of regulation, the risk of being caught and the relative benefits. Where the risks of detection are equal, non-price discrimination is typically optimal, given the lack of cost of implementation and the equivalence of the effects on downstream competitors.³ The difference in incentives is driven by the difference in the risks of detection. Price-based discrimination is more easily detected (see Bernheim and Willig (1996)). Due to the information asymmetry between the operator and the regulator it is likely that the regulator will be unable to determine whether the downstream rivals have been disadvantaged by discriminatory processes or through suffering an inferior quality of service. To be detectable, discrimination needs to be observable⁴ and, even if observable, it needs to be verifiable. Even if the practice is observable, it can be difficult for the regulator to gather sufficient evidence to ensure both a proper understanding of the value (to the downstream operator) of the discriminatory behaviour as well as making a fully informed decision about whether to prohibit the activity in question. This is particularly the case where the products in question are heterogeneous in nature, such as IP.⁵ The practical difficulties in detecting and verifying non-price discrimination increase the incentives to engage. Moreover, they render the threat of financial penalties largely impotent.

A natural question involves the extent to which existing regulatory tools are sufficient to rectify the problems identified. The BBC, for instance, may argue that its use of transfer price regulation prevents its commercial subsidiaries from acquiring rights at prices which

² See Economides (1998), Sibley and Weisman (1998), Mandy (2000), Weisman and Kang (2001), Reiffen and Ward (2002), Beard, Kaserman and Mayo (2001), Bustos and Galetovic (2003) and Sand (2003).

³ Price-based discrimination can lead to lower revenues from downstream markets, whereas non-price discrimination results in no such revenue reduction.

⁴ By way of illustration, the Italian competition authority (AGCM) found, in 2004, that Telecom Italia had engaged in non-price based discrimination, favouring its own retail operation over its rivals during an investigation into other types of abuses. In this case, the retail operation benefited from advantageous processes and service levels when dealing with the parent operation. However, despite the regulator having set the access charges for Telecom Italia's product it had no visibility of process or service quality aspects of Telecom Italia's activities. The existence of non-price discrimination was only discovered as a result of an investigation into other, more visible, forms of abuse. Reported in the International Competition Network 5th Annual Conference Proceedings. (see http://www.internationalcompetitionnetwork.org/media/library/conference_5th_capetown_2006/AppendixI.pdf).

⁵ We develop this issue below.

are both below market rates and which include a cross-subsidy. However, more than 20 years of regulation in the telecommunications and other utility sectors have illustrated the weaknesses of traditional measures to address discriminatory behaviour. Addressing non-price discrimination has proven particularly problematic. In a recent study for the European Commission, Hogan & Hartson and Analysys (2006) concluded that accounting separation remedies can be insufficient to address the problem of non-price discrimination. The lack of confidence in available regulatory tools to address non-price discrimination caused the US Federal Communications Commission (FCC, 2000) to conclude, in the context of a regulatory hearing, that it could not “*foresee every possible type of discrimination, especially with evolving technologies*” and “*hard-to-detect methods of non-price discrimination.*” In response to the practical difficulties of detecting non-price discrimination, the FCC has imposed strict functional separation requirements on certain telecoms operators wanting to enter vertically related markets under the 1996 Telecommunications Act. More recently, European regulators in telecoms and other utility sectors have come to similar conclusions on the weaknesses of transfer price regulation and general non-discrimination obligations. For example, the European Regulators Group (2007) has proposed that traditional measures, such as accounting separation, “*might not...be enough to prevent discriminatory behaviour from a vertically integrated operator.*” Moreover, they conclude that “*the enforcement of a non-discrimination obligation could be ineffective*” in dealing with the issue. Even BT (2006) which, like the BBC, is subject to non-discrimination rules, has conceded that “*the application of the principles of non-discrimination and transparency has failed to deliver...genuine equality of access...*”

Beyond the communications sector, we note that DG Competition (2006) has, in the context of the energy sector, expressed concerns about the link between vertical ties and discrimination. Its recently published Sector Inquiry argued that it was “*essential to resolve the systemic conflict of interest inherent in the vertical integration of supply and network activities, which has resulted in...discrimination.*” Remaining with the energy sector, the Second Gas Directive prescribes functional separation in order to reduce the risks of discrimination and cross-subsidy. DG Competition has argued, in the context of the Second Gas Directive, that incomplete legal and management separation creates conditions for discriminatory practices.⁶ Even where there is complete unbundling, DG Competition believes that incentives to benefit the downstream subsidiary through discrimination remain. Examples provided of behaviour conducive to discrimination include senior management from the subsidiary being represented on the board of the parent company, the sharing of physical assets, such as offices and staff canteens, and personnel and career related issues, whereby staff may move between parent and subsidiary as part of their career progression within the group – this concern extends to shared access to training programmes and business review meetings. DG Competition argues that unbundling is a necessary measure given the inability of regulatory models (and regulators) to address these kinds of activities and to accurately value any benefits derived by the subsidiary as a result of such activities.

We believe that functional separation of the BBC’s commercial activities from its parent organisation (including an end to BBC Worldwide’s preferred partner status) would be a useful step towards the elimination of sufficient conditions for cross-subsidy, would provide for a more effective means of regulating the relationships between the BBC and its commercial activities and would allow the BBC Trust to allocate its regulatory resources to

⁶ See DG Competition (2006) for further detail.

other aspects of the BBC's activities. Moreover, by creating conditions which are more conducive to competition for the commercial exploitation of BBC assets functional separation also benefits the Licence Fee payer.

Fundamentally, the regulatory framework must create conditions that are more conducive to a culture of non-discrimination than at present.⁷ Absent such a culture, detailed non-discrimination obligations will remain impotent. Like many regulators and regulated firms in other sectors, we believe that functional separation offers an attractive alternative model for the BBC (and other PSBs) to implement.

Vertical separation has been implemented in many countries (and in many markets) as a solution to the problem of discrimination. The OECD (2006) states that separation has the following potential advantages:

- Separation limits the need for regulation that is difficult, costly and only partially effective;
- Separation can stimulate innovation and efficiency in the production and the provision of competitive services;
- Separation helps to eliminate cross-subsidy; and
- Separation provides end users with a number of alternatives, enhances product differentiation and better meets end users' needs.

Functional separation exists along a spectrum of separation models, so we must be clear about what we mean. Functional separation requires that the downstream activity of the regulated party be placed within a separate business unit along with operational rules to establish effective Chinese Walls between this business unit and the regulated party's other operations. This represents a more restrictive intervention than is permitted under accounting separation, but it falls short of complete ownership separation. The regulated parent is obliged to maintain strict equivalence of relationships between all of its potential downstream partners and also, therefore, between its own downstream activity and competing companies. Ofcom (2005) has said that non-discrimination must be interpreted as meaning that all downstream operators enjoy "*the same timescales, terms and conditions and...the same systems and processes.*" We would support an explicit interpretation of the principle along these lines.

There are several approaches to functional separation (see the table below) and the appropriate form each Member State to consider in consultation with stakeholders. However, it should be made explicit in the Communication that preferred partnership relationships between the PBS and its commercial activities critically undermine the key objectives of the framework.

The main components of functional separation ⁸
Several of the measures mentioned here are mandatory (accounting separation, creation of a business unit, etc.), while others are optional and can sometimes be applied to differing degrees. And, finally, some components can only be imposed in conjunction with others.
<ul style="list-style-type: none">• Separation of functions

⁷ The existence and continued support for preferred partnership suggests, by definition, a culture of discrimination in favour of BBC Worldwide.

⁸ Adapted from ARCEP (2007).

- Creation of separate business units “A”, responsible for the production and supply of the products in question, and “B”, responsible for relevant downstream activities.
- Obligation to supply all operators under non-discriminatory conditions (equivalence/equality)
- Separation of operational support systems
- Separation of the brand (total = different name/partial = “B, a division of A”)
- **Separation of employees**
- Employees are not permitted to work some of the time for B and some of the time for another department of the incumbent
- Restrictions on the movement of B’s managers to the rest of the group
- Physically separate offices and places of work
- Pay incentives
- Code of conduct, notice boards, training
- **Separation of information**
- Limits on the flow of information between A and the other divisions (firewalls, Chinese walls)
- Implementation of separate access systems (information specific to the needs of the employee)
- Separation of information management systems
- **Financial separation**
- Accounting separation
- Separate budgets
- Financial autonomy
- **Separation of strategies**
- Separate management
- Separate management board, independent of the group
- Strategic investment decisions taken independently by B
- **Monitoring of compliance with obligations/performance**
- System for reporting breaches (integrated/independent)
- Independent complaint handling committee
- Sanctions applied in the case of default
- Publication of performance indicators (by an independent body/third party certification)
- Submission to the regulator of contracts signed between B and the incumbent (and/or alternative operators)
- Publication of compliance reports (by the regulator/by a third party)

The operational rules established aim in particular at controlling the flow of information between the parent operation and its subsidiary, as well as the behaviour of its employees, its mode of corporate governance as well as establishing appropriate commercial relationships. Functional separation appears to be a potentially effective way of dealing with the problems of asymmetric information flows between the regulator and the regulated firm and, in more general terms, with the issue of guaranteeing non-discrimination. The French communications regulator, ARCEP (2007), summarises neatly the main advantage of functional separation.

“Functional separation increases the transparency of the relationship between the divisions managing the parts of the network subject to the non-discrimination obligation and the other services offered by the incumbent, making discriminatory behaviour easier to detect by reducing the incentive for and/or the ability of the employees managing these parts of the network to grant preferential treatment to the incumbent’s own retail divisions to the

detriment of alternative operators, functional separation makes such behaviour far less likely.”

In theory, the implementation of functional separation, achieving greater transparency, as well as adequate incentives to provide equivalence of access to publicly funded assets leads to simplified and more effective regulation, as far as non-discrimination is concerned. Perceived benefits such as these have led to the adoption of functional separation as a regulatory tool across a range of sectors, from telecommunications to energy. In the US, the 1996 Telecommunications Act requires functional separation as a requirement of entry, by regulated players, into complementary markets. Similarly, functional separation has been required of Telstra, Australia’s incumbent telecommunications operator and arrangements have recently been put in place for functional separation in New Zealand. Closer to home, the Italian regulator has imposed a form of functional separation on Telecom Italia, whilst the Swedish regulator recently proposed a similar scheme. The European Commission’s proposed reform of the Communications Directives include references to the superiority of functional separation over more traditional methods as a means of “*significantly reducing the incentive for discrimination and...making it easier for compliance with non-discrimination obligations to be verified and enforced.*” (European Commission, 2007) That the European Regulators Group (ERG) has given the proposal its unanimous support needs to be considered in the context that the ERG has never before agreed unanimously with a European Commission proposal. The UK Government’s overwhelming support for the Commission’s proposals on functional separation should also be noted⁹, as should a recent speech by the Rt Hon. Stephen Timms MP, Minister of State for Competitiveness, in which he both praised the Commission’s proposals and credited Ofcom’s implementation of functional separation in the UK with the rapid growth in the competitiveness of the UK’s telecom market.¹⁰

Beyond telecommunications there is also acceptance of the benefits of separation as a means of addressing discrimination. In its recent Sector Inquiry on the energy market, DG Competition (2006) concluded that there “*are clear indications that ownership unbundling is the most efficient way to eliminate incentives for preferential treatment within vertically integrated operators.*” Europe’s energy markets have long been subject to regulatory requirements for functional separation of transmission and distribution and the current debate is whether ownership separation is a necessary next step. We do not believe that full ownership separation of the BBC and its subsidiaries is necessary at this stage. We note and support the view of DG Competition with regards the difficulties involved in addressing discrimination through more traditional means.

The appeal of functional separation should not be allowed to mask the challenges faced during implementation. In particular, the costs involved are greater than those found when implementing accounting separation. The main costs relate to the restructuring of the company, the duplication of key roles and the splitting up of functions where there may have been synergies.¹¹ As a result, there may be an increase in operational costs and complexity for the regulated party. Experience of functional separation in the UK suggests that it is not a substitute for other regulatory mechanisms, but should be regarded as a

⁹ See DTI (2006).

¹⁰ Speech to Chatham House, October 2007. Available at <http://www.dti.gov.uk/pressroom/Speeches/page42161.html>

¹¹ An obvious example would be the requirement that BBC World and the World Service should no longer share senior management under the Global News operation.

supplementary tool. It does not do away with the need to regulate other aspects of the regulated party's activities.

However, we note that the quasi-separation of the BBC from BBC Worldwide (and from its other subsidiaries) means that many of the recognised challenges have already been addressed in the case of the BBC. We believe that the operational cost to the BBC from implementing functional separation would be minimal and would in any case need to be set off against the value of the innovation and competition benefits that would follow. In terms of the potential benefits for the BBC, we note that in practice even those subject to functional separation have come to laud its advantages above its costs. The model has received considerable praise for its effectiveness. The UK Government has argued that *"this approach addressed legacy problems of ineffective, micro-managed regulation of the past."*¹² In the same report the UK Government also claims that functional separation would *"empower NRAs to impose obligations...to prevent price and non-price discrimination."* It has also found support, surprisingly, from those operators which have been made subject to the requirements. For example, BT claims that *"functional separation guarantees effective competition, together with more effective transparency and non-discrimination."*¹³ Additionally, Grant Forsyth, BT Global Services' Head of Global Interconnection, has said¹⁴ *"BT, Ofcom, competitors and consumers all benefit from the undertakings [functional separation]."* Firstly, he explains *"BT benefits from retaining the efficiencies of a vertically integrated operator."* Secondly, *"Ofcom benefits from having a clearer regulatory focus on the incumbent telecommunications operator, which is now subject to strict oversight of its compliance with non-discrimination principles."* And finally (and perhaps of greatest importance), *"...competitors can have greater confidence in the industry through a level playing field which will result in increased investment and innovation leading to greater choice and lower prices to the benefit of all consumers."*

2.5.3. *Do you consider that the rules for cost allocation as set out in the current Broadcasting Communication could be improved in light of experience in your country? If so, please give possible examples of good practice. Or do you consider that the current rules are sufficient?*

It is our experience that there are sufficient doubts as to the effectiveness of the regulation of transfer pricing that cost allocation must be used only in conjunction with fully effective functional separation and must even then be subject to effective scrutiny. Our response to this question is intended to illustrate the concerns that have caused regulators and competition authorities across the world and in different sectors to conclude that traditional approaches are not sufficient on their own for addressing concerns about discrimination and cross-subsidy.

a) Market testing

Conscious of the risk that BBC Worldwide may be acquiring rights from the BBC at rates below those prevailing in the wider marketplace, the BBC has occasionally made rights available to the market with the proviso that BBC Worldwide was not permitted to bid. It was hoped that this process would provide some greater understanding of the market value of BBC rights and provide guidance for Commercial Agency staff involved in trying to

¹² See DTI (2006).

¹³ See BT (2006).

¹⁴ See ARCEP (2007).

ensure that BBC Worldwide paid a market price for rights it acquired absent an effective and open competition.

Market testing has at least three flaws, which help to explain why the BBC stopped using it.¹⁵ Firstly, the heterogeneous nature of IP made it difficult to draw general conclusions about the prices paid by BBC Worldwide from the licensing of only a small sample of rights. Secondly, the rights made available for testing were never the BBC's most attractive rights. Finally, and perhaps of most significance, third parties would quickly determine that as BBC Worldwide was not in the market for the rights being offered, this process was primarily a compliance exercise. As a result, their willingness to participate honestly and to offer genuine valuations was greatly diminished. In summary, the valuations derived as a result of period market testing exercises were simply not sufficiently reliable for compliance purposes.

b) Cost-based pricing

A standard approach in regulation is to engage in some form of cost-plus or rate of return regulation. However, this approach suffers from a number of weaknesses which serve to undermine its credibility. As each IP-based asset is unique it would require a separate cost-model to be built for the purposes of valuation. This would be time consuming and impractical given the market value of many of the assets being sold. Even for specific assets, it would be difficult for the BBC to accurately value the intellectual contributions of all the staff involved in the creation of the asset, unless all staff are required to maintain time-sheets. The allocation of shared costs across projects and business units, including both public service and commercial, increase the difficulty of accurately apportioning costs. Our experience of working with regulators across the EU to model the costs of homogenous telecoms access products has given us a beneficial insight to the complexities and costs involved. In addition to the financial burden, such an approach puts on Licence Fee payers, it is not obvious that cost-based transfer pricing will maximise their returns. Market values of IP-based assets are rarely aligned with their production costs. This divergence renders cost-based pricing particularly unsuitable for IP-based transactions. There is no clear guidance on what would constitute an appropriate mark-up on costs for any particular asset or on what would represent a fair return on Licence Fee payers' investments. In particular, determining whether a PSBs rate of return is different from the competitive level is difficult. Perloff et al (2007) list eight major problems with benchmarking the rate of return. We summarise that list below:

- the use of accounting definitions, rather than economic ones means that capital is typically not valued appropriately;
- depreciation is typically measured improperly;
- expenditure on R&D, brand marketing and advertising is difficult to value due to its lasting effects;
- rates of return may not be properly adjusted for risk;
- some rate of return measures do not account properly for debt;
- proper adjustments need to be made for inflation; and
- monopoly profits may be inappropriately included in the calculated rate of return by using book value in the calculation.

c) Benchmarking

Given the weaknesses of market testing and cost-based pricing, the BBC has traditionally relied more heavily upon the process of benchmarking the rates paid by BBC Worldwide

¹⁵ Discussions with the BBC Trust suggested that the BBC was once again employing market testing.

and its other commercial activities. This can be done through comparing prices paid by BBC Worldwide (and its other activities) against published prices for comparable rights. However, where there is no comparable market price the BBC undertakes anonymous interviews with rival downstream operators to determine the values of different hypothetical rights or by examining the published accounts of similar organisations to determine their approach to internal transfer pricing. This final approach is particularly significant where the BBC looks to defend its pricing principles on the basis of incremental cost pricing. As we understand it, the BBC undertakes such an exercise once each three years.¹⁶ Whilst benchmarking can be a useful tool for regulatory purposes – it can be particularly valuable in cases involving allegations of predatory pricing – we have considerable doubts as to the effectiveness of benchmarking in this context.

There are some general weaknesses which undermine the value of benchmarking, which we will explain, followed by a more specific critique of measures employed by the BBC. Benchmarking requires that internal transactions are measured against comparable market transactions. This raises some general weaknesses which undermine the policy tool:

- Transaction specificity: perhaps the most critical weakness in the value of benchmarking is that, for accuracy, a new benchmarking exercise is required for each transaction. The heterogeneity of content means that general conclusions cannot accurately be drawn about one transaction based upon another, unrelated transaction. Each transaction is unique;
- Market definition: comparable transactions must take place within relevant economic markets that share the same economic characteristics. The greater the differences between the markets within which the transactions take place the less comparable the transactions become;
- Contract duration: longer contracts are likely to be more valuable than shorter contracts, even for similar content. Automatic renewal clauses may not be public knowledge so their presence could distort comparisons;
- Data inaccuracies: many critical aspects of contractual relationships are confidential. Even informed guesswork is not sufficient for an accurate comparison;
- Theoretical problems: the heterogeneous nature of content means that each seller has a different degree of market power and therefore a different degree of discretion over pricing (they may choose to price at different points on their downward sloping demand curves). Any benchmarking would need to adjust for differences in market power; and
- Intra-group services: where a comparable transaction is found involving another internal transfer, care is required to ensure that a similar approach is adopted to the internal charging for intra-group services, such as legal, finance, policy and strategy;

There are also a number of specific weaknesses in the benchmarking methods employed by the BBC. As we understand it, the BBC argues that incremental cost pricing of content licensed to BBC Worldwide and to BBC World can be justified on the basis of benchmarking. We believe that the BBC is unlikely to have sufficient information to properly identify another firm's incremental costs. The grounds for these doubts are summarised:

¹⁶ We understand that separate exercises are conducted for BBC Worldwide and BBC World.

- 1) Incremental costs are almost impossible to identify from publicly available information.¹⁷ The incremental cost of a particular activity is an expenditure which (a) was incurred as a result of the specific activity and (b) would not have been incurred absent the activity. As the nature of a firm's cost structure may differ across products, over time and with the level of production, simple before and after comparisons of costs, based on published accounts, can easily lead to the misidentification of incremental costs. It is typically difficult to meet the causation standard by relying on the cost categories in published accounts. For example, firms sometimes list categories of costs as variable and fixed or direct and indirect. Structuring data for accountancy purposes does not provide the granularity required for the identification of incremental costs relevant to a particular activity. Costs that are labelled as "variable" in a published account may not vary at all with the activity in question and costs which are usually considered as "fixed" may vary in reasonable but-for scenarios. A particular challenge exists where production costs are non-linear. Scale economies may allow total costs to increase at a decreasing rate as production increases. Similarly, a firm may benefit from economies of scope or learning. Any of these characteristics may cause costs to increase slower or faster than volume. Thus, it is possible that some "fixed" costs are incremental to the activity in question, while some "variable" costs are not.

Multi-product settings further complicate incremental cost analysis. When a firm engages in a new activity it may require additional management or supervisory resource. Although these costs, strictly speaking, are incremental they will typically be reported as overhead costs in the firm's published accounts. Published accounts do not typically report sales of discrete products, so there may be little information on what product mix the firm produces and how the product mix would have differed had the activity in question not been undertaken. If the but-for scenario entails a production process with a cost structure significantly different from the costs characterising the firm's actual production, an analysis of the firm's actual cost structure may lead to incorrect estimates of the relevant incremental costs.

Even where published accounts do list costs separately for individual product lines, the reported costs are often the result of accounting allocation rules that bring a whole new set of complications to the analysis. In the case of multi-product firms, costs are typically allocated on the basis of sales volume or some other driver of activity rather than by causation.

Unless the BBC (or its consultants) understand the underlying methodology behind the published accounts and are able to properly adjust the cost information, it is unlikely that their analysis will yield an accurate picture of the firm's incremental cost for the activity in question. This should not be surprising, as public accounts are not created for the purpose of evaluating the profitability of a specific product or activity. Whilst competition authorities regularly employ analysis of published accounts when investigating allegations of predatory pricing, they also employ their powers of discovery to review the firm's cost structure and to question financial personnel and other executives to determine cost causation. Neither the BBC nor the BBC Trust has legal powers of discovery.

- 2) Identifying the correct benchmark can be problematic. The BBC also considers whether the prices paid by its commercial activities, whether BBC Worldwide, BBC World or some

¹⁷ Similar problems arise when benchmarking transfer prices more generally. Our criticisms apply not only to the identification of incremental costs.

other, are similar to those found in comparable transactions in the wider market. This raises issues about correctly identifying appropriate transactions against which to benchmark. For example, the BBC benchmarks transfer pricing of news content to BBC World against the internal transfer pricing practices of integrated news suppliers, such as CNN and NBC. The relevance of the internal transfer pricing practices for the BBC-BBC World relationship is highly questionable, given that there is a well functioning and transparent market for news content. Moreover, organisations such as CNN and NBC, are not subject to prohibitions on cross-subsidy and are not bound by rules governing State aid. Whilst these organisations are perfectly entitled to subsidise specific internal activities, the BBC is prohibited from subsidising its commercial activities. It is safe to say that the market price of news content is above marginal cost, but the BBC chooses to maintain, without any justification that the correct benchmark is internal transfer pricing. In addition, and as explained above, internal transfer prices are often derived from accounting rules, rather than by cost causation.¹⁸ It is far from certain, therefore, that benchmarking against internal transfer pricing is appropriate or even effective for determining whether a particular transfer pricing methodology is appropriate for the BBC, given its unique regulatory constraints.

Care is required when selecting the correct benchmark. Just as the “buying” activity can benefit from too low a price, foregone revenue can be a sign of overcompensation. We would welcome an explicit notice that incremental cost pricing, even if correctly applied, does not equate to ensuring that the price paid is a fair market price.

- 3) The public service nature of BBC content makes benchmarking impractical as a tool. Unlike commercial content producers who create content for commercial markets, with the requirement to balance the interests of advertisers, subscribers and viewers, the BBC’s sole purpose is to produce high quality public service programming. It should do this without a view to its subsequent commercial value. That makes it difficult to find comparable content in the market against which to benchmark.
- 4) Benchmarking does not capture information advantages and other non-price benefits. It is unclear how the BBC captures the benefits its subsidiaries enjoy as a result of their close operational relationships with the BBC. For example, BBC Worldwide staff interact with public service colleagues on a more regular basis than staff working for rivals to BBC Worldwide. This raises the risk that BBC Worldwide will benefit from discriminatory access to information on the BBC’s plans. How are these benefits captured within a benchmarking framework? As BBC Worldwide is insulated from having to compete for a major proportion of its input materials, it faces a lower level of risk than its rivals. How does the BBC capture the value to BBC Worldwide of not having to compete for access to BBC content?

With the BBC facing an absolute prohibition on cross-subsidy, there is a requirement that there can be no cross-subsidy involved in the transfer of any particular asset being licensed to the BBC’s commercial activities. It should be noted that the BBC’s approach can, at best, identify a range of prices against which the BBC’s internal transfer prices can be benchmarked. As this is a range, we cannot be certain that there is no cross-subsidy involved in individual transactions. Similarly, they cannot be certain that the prices paid reflect a fair market price.

¹⁸ Certainly, CNN does not apply the two-part incremental cost test that an economist would apply when testing for incremental cost pricing.

There is an additional, more fundamental challenge to address when applying the incremental cost test for cross-subsidy. The BBC is correct in identifying that the incremental cost test is supported by economists as one test for cross-subsidy (Faulhaber, 1975), but great care is required in interpreting the requirements of the test. It is of course for the BBC to convince the BBC Trust (and ultimately the UK Government) that it has correctly applied the test, but it is reasonable to suspect that the BBC may not be implementing the test properly. It is important to ensure that the incremental cost test is applied not only to individual services, but to all possible bundles of services that are subject to transaction between the parent and its subsidiary - the incremental cost test is a two-part test (Faulhaber, 2005). The combined revenue from all possible bundles of the firm's services must also be greater than the incremental cost of providing that bundle of services. The requirement that the test must be applied to all possible bundles, in addition to having been applied to the individual service, is often "forgotten" in practice, given the cost and complexity involved. Applying the incremental cost test only to individual services cannot be considered as being a "good enough" approximation. According to Faulhaber (2005), "*it is a fatal error.*" The cost and complexity of properly applying the test would suggest that is not feasible for the BBC to apply it properly in every case. It is of course, a matter for the BBC to prove to the BBC Trust and UK Government that it correctly applies the two-part test for the transfer for every individual asset to its commercial subsidiary. Failure to do so would mean that there can be no guarantee that the transfer is subsidy-free.

We would welcome a statement in the Communication such that transfer price regulation should be recognised as a complement to structural remedies as a means of addressing discrimination. Moreover, it should not be viewed as a substitute to non-discriminatory licensing for the purposes of determining whether a PSBs commercial subsidiary has acquired rights at market rates.

2.5.4. Against the background of your answers to the previous questions (2.5.1, 2.5.2, 2.5.3), do you consider that a revised Broadcasting Communication should contain further clarifications of transparency requirements?

As a minimum, Member States should be required to impose functional separation between the public service and commercial activities of their PSBs. Functional separation should be viewed as a complement to more traditional measures, such as cost allocation, as explicit means for addressing discrimination (both price-based and non-price).

2.6. Proportionality test – Exclusion of overcompensation

2.6.1. Do you consider that the Broadcasting Communication should include a requirement for Member States to clearly lay down the parameters for determining the compensation amount?

We would support the inclusion of a requirement for Member States to clearly set out the parameters for determining levels of compensation. In particular, we would ask that the Communication provides guidelines to Member States on how to prevent over-compensation as a result of foregone revenue. For instance, where PSBs also undertake commercial activities Member States should be required to determine levels of compensation assuming an efficient pursuit of commercial revenues. Where the PSBs' commercial activities are inefficient, relative to their market competitors, the withholding of

public funds would be an appropriate means of applying discipline in the absence of effective market pressures.

2.6.5. Do you consider that the current rules laid down in the Broadcasting Communication could possibly act as a disincentive for public service broadcasters to achieve efficiency gains? If so, how could this situation be remedied? What are the mechanisms in place in your country which could be referred to as a good example?

The persistent running of a surplus could be evidence of overcompensation where it can be shown that ceteris paribus that PSB is operating inefficiently. We would recommend that where a Member State proposes to permit its PSBs to operate with a surplus they are then required to prove that the PSB is operating efficiently. In particular, the Member State should be required to ensure that the PSB is operating efficiently in its commercial activities in order that it is not forgoing revenues that could otherwise be used to offset public funding. In the context of the UK, we welcome the role of the National Audit Office (NAO) in scrutinising the value for money provided by the BBC, but would recommend that the NAO be given full independence to scrutinise any aspect of the BBC's activities, rather than having to work in conjunction with the BBC Trust.

2.7. Proportionality test – exclusion of market distortions not necessary for the fulfilment of the public service mission

2.7.1. What are the available mechanisms in your country under which private operators could challenge alleged anti-competitive behaviour of public service broadcasters? Please indicate whether you consider that these mechanisms ensure a sufficient and effective control. Are lower revenues due to demonstrated anti-competitive behaviour (e.g. price undercutting) taken into account when determining whether or not the public service broadcasters have been overcompensated?

Private operators are able to pursue complaints of abuse of dominance by the UK's PSBs through the conventional competition authorities, the Office of Fair Trading (OFT) and the Competition Commission. In addition, complaints can also be pursued through Ofcom, which enjoys concurrent competition powers under the Competition Act 2000.

Complaints of unfair trading (e.g. cross-subsidy and discrimination) by the BBC's public service and commercial activities can be pursued through the BBC Trust. Although the BBC Trust is not a competition authority, it is empowered to ensure that the BBC complies with the requirements of the Royal Charter and Agreement.

Whilst we have considerable respect for the OFT and Ofcom, reliance on national competition law is problematic. Most concerns about the impact of PSBs on the market relate to their receipt of public funding and the risks that such funding can be used to cross-subsidise commercial activities. A common complaint, for example, is that the BBC fails to charge BBC Worldwide and BBC World a market comparable price for licensed IP. As the BBC explicitly discriminates in favour of its commercial activities when licensing its publicly funded IP, it cannot be possible for the BBC to determine that the price paid by its activities reflects the market price. Where a PSB is not dominant, for the purposes of competition law, then the competition authorities are largely powerless to intervene. Apart from the BBC Trust, the weaknesses of which are outlined above, there is little scope to seek effective remedy at a national level when the issue relates to public funding and what it is used for. Although the BBC Trust consults on proposed public services, using a public

value test which fails to explicitly consider whether there is a persistent market failure, it does not consult on proposed commercial activities. We believe that the lack of transparency with regards the PSBs' commercial activities raises the risk that their inefficient performance could amount to forgone revenue and, as a result, over-compensation.

2.7.2. As regards the possible anti-competitive behaviour of public service broadcasters (and in particular as regards allegations of price undercutting), do you consider that the Broadcasting Communication should include requirements for public service broadcasters to respect market conditions as regards their commercial activities in line with Commission decision-making practice, including appropriate control mechanisms?

The Communication should require, as a minimum, that Member States impose obligations on their PSBs to avoid pricing below market rates. In support of this requirement, the Communication should offer guidance on how to ensure that a market price is paid. This should incorporate a requirement to operate in a non-discriminatory basis when licensing publicly funded assets for commercial exploitation. It should also be noted that while incremental cost pricing can safeguard against cross-subsidy, it does not ensure that the subsequent price is in line with comparable market prices. Due to their high fixed costs/low marginal costs nature, the market price for IP products is rarely correlated with their incremental production costs. The Communication should require Member States to address effectively the risk that pricing below market prices, even where above incremental costs, constitutes forgone revenue. Unless the PSB can show that prices charged are in line with prices charged in comparable market transaction, reflecting that the PSB should be required to treat its commercial activity as it would any genuine third party (i.e. on a non-discriminatory way), then the forgone revenue should be recognised in setting compensation levels. Otherwise there is likely to be overcompensation and little incentive on the PSB to operate its commercial activities efficiently.

2.7.3. Do you consider that the methodology for detecting price undercutting should be clarified, possibly also including other tests which could be used as an alternative to the methodology currently referred to in the Broadcasting Communication? Please make reference to tests applied in your country to the pricing behaviour of public service broadcasters and which could be used as an example of good practice.

Clarification of the methodology for detecting price undercutting would be welcomed. It should be made explicit that the incremental cost test may be sufficient for testing for the presence of a cross-subsidy, but that it is not a sufficient test for market pricing in markets for IP products. Therefore, it cannot be used to test for forgone revenue. Where incremental cost pricing is to be used to determine the floor below which a transfer would involve a cross-subsidy, the Communication should clarify that both parts of the Faulhaber two-part test are required. Failure to employ both parts of the test, which is a common error, renders the application of the test fundamentally flawed. Further, it should also be explained that traditional methods, such as benchmarking and regulating transfer pricing should not be considered as an effective substitute for operating a non-discriminatory licensing policy, coupled with a framework of functional separation. In particular, these traditional methods have proved ineffective at addressing problems caused by non-price discrimination.

London 10 March 2008