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Regulating the BBC

Professor Martin Cave*, Warwick Business School, United Kingdom
Professor Richard Collins**, The Open University, United Kingdom
Dr Peter Crowther***, LeBoeuf, Lamb, Greene & MacRae, United Kingdom

'Finally, there is the situation of the BBC, which provides services that are primarily free at the point of delivery in return for about £2.5 billion per annum in tax payers' money – not far off one day's gross domestic product for the U.K. The increasing tendency of the BBC to launch services or markets beyond its traditional public service broadcasting remit, such as web-searching, has aroused considerable public interest and could raise difficult competition issues' (Vickers 2002: 4).

Keywords

BBC, Competition, Regulation, ex ante, Ofcom

The BBC is active in an increasing number of markets. In some cases the BBC enters the market using licence fee income; in others its commercial operations have linkages with licence-fee activities – for example, by provision of resources for programme making, joint funding of programmes, trailing of commercial products, and so on. These situations raise serious competition issues. The authors conclude that theory and evidence suggest exceptional risks that anticompetitive practices by the BBC will discourage private sector initiative and investment in broadcasting and related markets and recommend strengthened ex ante regulation of the BBC by Ofcom.

1. Introduction

The United Kingdom is approaching the beginning of a new broadcasting policy regime. A new Communications Act, which will integrate broadcasting regulation with regulation of other electronic communication services (notably radio frequency spectrum allocation and telecommunications regulation) was passed in July 2003. The Competition Act 1998 and the Enterprise Act 2002 also imply important changes to the basis on which, hitherto, broadcasting has been regulated in the United Kingdom. The perennial question of how to balance satisfactorily the cultural and commercial dimensions of broadcasting policy is being re-addressed, with an inevitable focus on the challenges presented by the BBC.¹

* Warwick Business School, Coventry, CV4 7AL. Tel: +44 (0) 24 7652 4506. martin.cave@wbs.ac.uk

** The Open University, Milton Keynes MK7 6AA. +44 (0) 1908 652231 R.E.Collins@open.ac.uk

*** No.1 Minster Court, Mincing Lane, London EC3R 7YL. +44 (0) 207 459 5112. peter.crowther@llgm.com

¹ For an earlier analysis with a different emphasis see Bonn & Prosser (2001)

The salience of the BBC in UK broadcasting is easily forgotten. It supplies 38% of television viewing and 53% of radio listening. The BBC accounts for half of the television programme supply market and its commercial activities alone (depending on how intergroup transfers are treated) are between 3 and 5 times the turnover of Channel 5²! The BBC's impact on the broadcasting market is enormous both culturally and economically. Given this, it is unlikely that the Government's proposals will provide a satisfactory basis for the achievement of the UK's broadcasting policy goals – goals which the Government defined as a “dynamic, competitive communications industry... universal access to a choice of diverse services of the highest quality; and ensuring that citizens and consumers are safeguarded” (DTI/DCMS 2002: 3). We share Born and Prosser's recognition (2001:658) that public service broadcasters can lose their commitment to public service broadcasting – defined by them as an “appeal to principles of citizenship, universality and quality”. There is some evidence that the contemporary BBC no longer fully adheres to these principles³ and that some UK broadcasters, formally in the commercial sector, such as Artsworld better exemplify these principles than do broadcasters, such as Channel 5, which formally are part of the UK's public service broadcasting system and consequently enjoy the privileges of that status (such as must carry rules, low cost spectrum etc).⁴ Moreover, the potentially anti-competitive impacts of the BBC's commercial activities have also aroused concern.

To take a specific case in point, consider the potential for public service broadcasting to “crowd out” actual, or potential, provision by other suppliers with an adverse impact on diversity and pluralism. Crowding out is a difficult argument to substantiate for it turns on a hypothetical question – would “y” have happened had not “x” happened? But the Davies Panel took the problem sufficiently seriously to consider it⁵ and there is some significant contemporary evidence to suggest that crowding out by a public service broadcaster, with, in consequence, an adverse effect on competition, diversity and pluralism is not simply a theoretical concern. Three CEOs of small UK based digital television channels interviewed by us have testified to the threat posed by the BBC. John Hambley, Chief Executive of Artsworld,⁷ testified to the difficulty Artsworld, and other similar channels, experienced as a consequence of the mutually reinforcing advantages enjoyed by the BBC. Geoff Metzger, Managing Director of The History Channel,⁸ stated that he was “very concerned about the launch of the BBC's commercial service, “UK History”, and referred to the aggressive business plans foreshadowed by the director of UK History, Matt Tombs.⁹ Metzger further stated that “anyone entering the market now¹⁰ does so with knowledge of much greater risk”. The Chief Executive of Digital Classics¹¹, Chris Hunt,¹² made the most powerful criticism of the BBC and stated that it “had

² Channel 5 is an advertising funded UK free to air terrestrial television channel.

³ See, inter alia, Thompson (2000) and Collins (2003).

⁴ The UK's television market is complex. Terrestrial, analogue, free to air television is the longest established and most important market sector. It comprises the BBC's two licence fee funded channels; the ITV commercial network (Channel 3); the advertising financed non-profit distributing Channel 4 (in Wales S4C) and the commercial Channel 5 (now called five). These channels are all formally regarded as public service broadcasting. From the 1980s additional commercial channels became available on cable and satellite platforms of which the most important (and offering the most commercially successful programming) is the digital satellite operator BSkyB. Digital terrestrial services began in 1998 but the provider, On Digital later renamed ITV Digital, ceased trading in 2002 and was replaced by free-to-air platform “Freeview”. The BBC provides a variety of digital services on “Freeview”. These services are also available on digital satellite.

⁵ A 1999 government sponsored enquiry into BBC funding headed by Gavyn Davies, who subsequently became Chairman of the BBC Governors

⁶ See discussion “Fair trading or foul?” around 91-4 in Davies (1999).

⁷ Interviewed 12.9.02. Artsworld is a UK subscription financed digital television channel carried on Sky's satellite platform. Currently, Artsworld has fewer than 50,000 subscribers and in mid 2002 there was serious concern about the prospect of the imminent closure of Artsworld's services.

⁸ Interviewed 2.10.02.

⁹ See Ariel 18.9.02: 6.

¹⁰ That is, after the announcement of impending establishment of the BBC's “UK History” channel.

¹¹ An arts channel that went off the air in consequence of the BBC's impending launch of BBC4, a free-to-air digital arts channel.

¹² Interviewed 30.9.02.

the market power and the will to take out the opposition”. Hunt further stated that “we would still be running were it not for BBC4”. These three channels, one now defunct, can plausibly be considered to offer programming no less public service in character than the BBC’s and suggest that the potential for the BBC to crowd out competition, identified by the Davies Panel, is more than theoretical.

If the Government’s objectives are to be achieved, and UK broadcasting is to sustain public service principles, a more stringent regulatory regime is required for public service broadcasting, and the BBC in particular, than that embodied in the 2003 Communications Act.

This paper discusses how adequately the Communications Act 2003, in conjunction with competition legislation – the Competition Act 1998 and the Enterprise Act 2002, protects companies and customers from the BBC’s anti-competitive behaviour. This is quite distinct from the much debated issue of who should regulate the BBC in the discharge of its obligations as a public service broadcaster – the Board of Governors or OFCOM¹³. Instead, we focus on issues that can most simply be described as the economic regulation of competition and offer proposals for a stronger *ex ante* regulatory regime than that adopted by the Government.

The paper is organised as follows: Section 2 describes the BBC’s current range of activities, in relation to those provided by other commercial broadcasters. This identifies areas where the BBC is most likely to impinge upon commercial suppliers. Section 3 sets out the current legal and regulatory framework relating to the application of competition law to the BBC.

Section 4 considers competition issues arising with respect to services funded by the licence fee. These are determined by the process by which the BBC gains agreement to provide the services. This is essentially a political decision, but one which may have major consequences for competitors.

Section 5 discusses issues arising in relation to the BBC’s ‘commercial’ services, not financed directly from the licence fee. These include BBC Broadcast, BBC Resources, BBC Technology, and BBC Worldwide. They represent activities historically undertaken by the BBC, rather than actions taken to discharge public service broadcasting obligations. As a result, they can be evaluated from a ‘standard’ competition standpoint without the added complication of the special feature of licence fee finance.

This provides a basis, in Section 6, for considering the adequacy of possible arrangements for dealing with potentially anti-competitive conduct. These include structural solutions, the application of competition law and *ex ante* regulation.

Why focus on the BBC alone, rather than including other broadcasters, many of which have public service obligations under existing and the proposed legislation? That issue is discussed below, but in essence we argue that the BBC’s entitlement to a licence fee imposed upon viewers for the right of access to any broadcast service places it on a different footing from publicly or investor-owned broadcasters such as Channels 3 – 5 which are required to generate the whole of their revenues from the sale of (mostly advertising) services. In particular, in the case of Channels 3 – 5, there is no issue comparable to that of ensuring the BBC make proper use of licence fee funding, particularly in respect of activities which compete with those provided on a commercial basis by broadcasters and others. Moreover, the size of the BBC gives it the capacity to distort competition in a variety of market places.

Before embarking on the study, it is helpful to address the question of whether a public broadcaster such as the BBC is likely to have the motive to behave in an anti-competitive way. At first sight, it

¹³ Ofcom (Office of Communications) is a new regulatory agency to be established under the Communications Act 2003. Ofcom is to integrate five formerly separate agencies; the Broadcasting Standards Commission (BSC); the Independent Television Commission (ITC); the Office of Telecommunications (OfTel); the Radio Authority and the Radiocommunications Agency.

may seem that an organisation not subject to the profit motive may lack the incentive to behave in a way which distorts competition, but might instead act as a countervailing force to anti-competitive conduct by other firms. In addressing this issue, it is important to specify our assumptions about the motives guiding the behaviour of public firms. These are often represented in simplified form as the desire to maximise not profits, but output - the scale and scope of the firm's activities¹⁴. If that is the case, then there are *a priori* grounds for supposing a public firm is likely to behave more aggressively than an otherwise equivalent investor-owned firm in excluding its competitors from markets or weakening their ability to compete in those markets. This implies that a public firm may be prepared to expend resources to eliminate or weaken a competitor, without the expectation of long-run positive returns.¹⁵ If, moreover, the public firm's expanded activities are subsequently validated through a higher licence fee, the incentives to grow are even stronger.

Given the Government's objective of developing a dynamic competitive U.K. broadcasting industry, it is vital that actual or potential suppliers are assured of protection against anti-competitive conduct by the BBC (and others). If this condition is not achieved there is a serious risk that not only the broadcasting market, but related markets will be handicapped by:

- lack of diversity of supply;
- lack of innovation;
- unwillingness of overseas companies to make investments in the UK;
- inability of UK companies, other than BBC, to generate sufficient scale to supply overseas

These issues are not solely economic. The Government has stated that citizen and consumer interests are important policy considerations. If the BBC behaves anti-competitively then diversity and pluralism are likely to be compromised as entry to broadcasting markets by new firms may be chilled.

2. The BBC's Role in the Market Place

In this section we briefly summarise the activities undertaken by the BBC and its competitors. Some areas are reliably documented; in others our information is less complete.

2.1 Broadcasting

Broadcasting in the UK is principally provided by vertically integrated organisations operating in markets with significant barriers to entry. These structures have been created through public policy and regulation.

Transmission of programmes to the final consumption market is constrained by restricted access to each of four main transmission infrastructures: analogue terrestrial, digital terrestrial, cable, and satellite. Of these, analogue terrestrial and satellite services (non digital) potentially reach almost all UK homes. Cable, because of the high cost of extending service to remote communities, is not likely to approach the levels of availability of analogue terrestrial and satellite services. The coverage of digital terrestrial is largely a policy variable.

Analogue terrestrial radio and television services are received in almost all UK homes. Satellite services potentially have an equivalent reach, but only 24% of UK TV homes have acquired reception equipment. Only 12.5m of UK homes are passed by cable (and of these 3.5m, or 14% of TV homes subscribe: of these 2m or 8% have access to digital services via cable), and only 5% of UK TV

¹⁴ See, *inter alia*, Lott, J (1999) and Sappington, D and J G Sidak (2000).

¹⁵ Sidak (2001) and Sappington and Sidak (2002) address this issue by reference to the conduct of Deutsche Post and the take-over of Voicestream by Deutsche Telekom.

homes have access to digital terrestrial television. Overall, 41% of UK TV homes have access to digital television using different infrastructures as follows: satellite (28%), cable (8%), DTT (5%).¹⁶

The Government is committed to a switchover to digital broadcasting some time after 2006 and not later than 2010, and although some question (Collins 2002 and Elstein 2002) whether that is a realistic deadline there can be little doubt that the digital market is likely to grow in importance though it is too soon to judge how it is likely to evolve. Among broadcasters, the BBC and BSkyB (Sky) are best placed to supply digital services – Sky through its existing retail market share and dominance in the wholesale supply of premium channels, and the BBC through its existing access to all platforms and its recent acquisition, jointly with BSkyB and Crown Castle, of the DTT multiplex licences, previously held by ITV Digital, now known as Freeview.

The most watched, and most widely available, UK television *channels*, BBC1, BBC2, ITV/Channel 3, Channel 4/S4C and Channel 5 are all classified as public services. They thus benefit from “must carry” rules obliging cable networks to provide these services to subscribers, and digital services will benefit from satellite “must carry” provisions. BBC national and local radio stations are also defined as public service channels¹⁷. “Must carry” provisions endow qualifying channels with superior access to final consumption markets than that enjoyed by commercial channels.

These public service broadcasters enjoy, through a combination of regulatory requirements (must carry rules) and a historical accumulation of mutually reinforcing advantages (notably comprehensive roll out of analogue transmission infrastructure, universal distribution of analogue receiving equipment etc), the widest and cheapest availability of access to consumers. Not surprisingly, in spite of the large number of channels available in the UK across different transmission platforms (cable, satellite and terrestrial), they dominate the UK market for final *consumption* of broadcast services¹⁸.

In 2001 the five main PSB *television* channels accounted for 80%¹⁹ of UK television viewing.

- BBC 1 and 2: 38%
- ITV (including GMTV): 27%
- Channel 4/S4C: 10%
- Channel 5: 6%

Other services, on cable, digital terrestrial and satellite platforms, provided by public service broadcasters, accounted for an additional 2% of consumption. Total provision by public service broadcasters therefore accounted for 83% of television consumption in 2001.

If, as has been generally regarded by national and international competition authorities, the free to air television market is regarded as a separate market from the subscription television market, PSB accounts for 97% of television consumption in that market. Rebased viewing shares to take account only of the free to air analogue market, individual broadcasters’ shares are as follows:²⁰

¹⁶ Data derived from 2002 fourth quarter cable statistics at

http://www.ofcom.org.uk/industry_market_research/m_i_index/tv_radio_region/itc_market_info/cable_sat_stats/multichannel_q4_2002.pdf

¹⁷ For data on the complex and pluralised UK radio sector see the websites of the BBC www.bbc.co.uk and the radio audience research body RAJAR (www.rajar.co.uk).

¹⁸ We focus on broadcasting for reception in the UK and therefore do not consider the BBC’s External and World Services (funded by the Foreign and Commonwealth Office and not the domestic licence fee) or television services whether UK owned, such as the BBC’s BBC America, or non-UK owned, such as TvDanmark 1, designed for consumption outside the UK.

¹⁹ Percentages are rounded and do not sum to 100% - roughly cable and satellite channels accounted for 20% of UK TV viewing).

²⁰ From ITC Television Audience Share Figures 14.2.2002. at www.itc.org.uk However, due to the abolition of the ITC in consequence of the establishment of Ofcom on 29.12.2003, the ITC website no longer exists and this data is no longer accessible via the ITC site.

- BBC: 46%
- ITV (including GMTV): 32%
- Channel 4/S4C: 12%
- Channel 5: 7%²¹

In *radio*, the BBC accounted for 53% of radio consumption in the first quarter of 2002. The BBC's radio share is overwhelmingly based on its dominance in the national radio market. BBC local and regional radio accounts for only an 11% share of listening. National commercial radio accounts for 8% of listening.²²

If all *revenues* in the UK television market are considered, public service broadcasters accounted for the following percentages of total 2001 revenues (where BBC revenues are proxied by spend on the relevant services).

- BBC: 21%
- ITV: 24%
- Channel 4/S4C: 8%
- Channel 5: 3%

Total UK TV revenues in 2001 amounted to £7,8bn of which the BBC licence fee spend on television amounted to £1,7bn; ITV (including GMTV) £1,9bn; Channel 4/S4C £0.6bn; Channel 5 £0.2bn²³.

Thus, looking at the total UK broadcasting consumption share, in 2001, the BBC accounted for 38% of UK TV consumption and UK 53% of radio consumption. In terms of revenue shares the BBC accounted for 21% of television (38% of the free-to-air analogue market) and 50% of radio revenues

2.2 *Upstream Activities*

Other possible relevant markets include those for programmes and for other factors of production. Programme supply was (partly) liberalised as a consequence of the “independent production quota” (for ITV, Channel 4, Channel 5, the BBC) of 25% of qualifying programmes prescribed in the 1990 Broadcasting Act.²⁴ Channel 4, for historical reasons, screens a much higher proportion of independent productions, which accounted in 2001 for 61% of transmissions. According to Merrill Lynch (2002) data, the BBC accounted for about 50% of television programme expenditure by free to air broadcasters in 2001.

PACT, the Producers' Alliance for Cinema and Television, the trade association of independent producers, claims that the quota is a ceiling rather than a floor. And that the BBC and ITV (Channel 3) networks treat the 75% of the programme market that is, in theory, open both to in house and independent producers, as a guaranteed market for in-house production from which independent producers are effectively excluded.²⁵ PACT argues that BBC's Commercial Policy Guidelines do not

²¹ Additional unencrypted services on cable, satellite and digital terrestrial platforms accounted for the remainder of free to air viewing.

²² Radio share data at www.rajar.co.uk

²³ Data derived from un-numbered table “Sources of UK TV Revenue” at para A23. DTI/DCMS(2002a).

²⁴ Section 16(2)(h) Broadcasting Act 1990 sets out the regime for ITV and Channel 5, Section 25(2)(f) for Channel 4 and Section 186 for the BBC. The Director of Fair Trading is required to report annually on the BBC's performance in this regard.

²⁵ PACT has made a series of unsuccessful complaints to the OFT about the contractual terms for programme supply offered to independent producers by the BBC (in 1999 and 2001). Essentially, PACT's case is that the BBC offers only “fully funded” commissions to UK producers and accordingly the BBC acquires all IP rights as a condition of contract. However, PACT declined to supply specimens of the offending contracts and there are undoubtedly some independents, e.g. Ragdoll with the “Teletubbies” series, which have retained rights to

cover programme supply and its trading arrangements differ from those which obtain with the ITV network where programme acquisition and network scheduling is decoupled from the direct influence of the programme producing ITV companies. The ITC's Review of the UK programme supply market bears out this analysis and identifies, inter alia, "The opportunity for the BBC in particular... to lever market power in the primary rights market, into the distribution market" (ITC 2002: para 168).

2.3 Commercial Activities

Competition concerns may also potentially arise in connection with other upstream activities, for example in respect of inputs to programme production. The BBC has established a wholly owned subsidiary company, BBC Resources, to provide services such as studio and outside broadcast facilities (in 1999 the Davies Panel had recommended BBC Resources should be divested).²⁶ Although in 2002, the Director General of Fair Trading (DGFT) advised the Secretary of State not to refer a proposed joint venture for supply of studio facilities in Manchester between BBC Resources and Granada to the Competition Commission, having found the market to be competitive,²⁷ concern about the BBC's upstream activities has not been wholly allayed. BBC Resources lost £13 million in 2000/1 and £6 million in 2001/2. No separate data on profitability were published in the accounts for 2002/3. There is room for more than one view on the length of time such losses would be borne by private sector companies operating under 'normal' commercial principles and seeking an appropriate rate of return on capital employed.

The principal other BBC subsidiaries are BBC Worldwide (exploiting BBC content and intellectual property in the UK and overseas), BBC Technology (providing web and other corporate technology services) and BBC Broadcast (providing sub titling, creative services and channel management). The terms on which these companies supply to the BBC are characteristically more representative of intra-corporate transfers than of open competition – far from all are tendered publicly and the relatively few contracts awarded outside the BBC are reported to be used to benchmark prices used for the majority of contracts which are still largely between the BBC and its commercial subsidiaries. The services provided by these companies include:

- programme exports and international television channels;
- video and DVD sales;
- books and audio books;
- magazines;
- interactive design;
- outside broadcasts;
- media production facilities;
- media streaming and hosting;
- systems integration;
- playout, media planning and channel management;
- trails;
- access services such as audio description and sign language;

2.4 Assessment

It is not possible here to undertake a competition analysis of the markets in which the BBC is engaged. This would require a rigorous approach to market definition, followed by an analysis of each market thus defined.

overseas markets after selling to the BBC. Nonetheless, the ITC found that "the market is not working effectively ... and ... that there are good prima facie grounds to believe there are competition problems" (ITC 2002: para 25).

²⁶ *Op.cit.* in footnote 4.

²⁷ OFT Press Release, Proposed joint venture between BBC Resources Ltd and Granada Media Group Ltd, 23/07/2002.

There is, however, *prima facie* evidence for concluding:

- that the BBC is at or close to a position of dominance in a number of markets;
- it is using this position to enter a number of horizontally or vertically related activities;
- inevitably opportunities will arise for the leveraging of market power, to the detriment of competitors and consumers

3. The Legal and Regulatory Framework

This section summarises the principal competition aspects of the legal and regulatory framework under which the BBC operates.

3.1 The Competition Act 1998

The Competition Act prohibits agreements that have as their object or effect the restriction, prevention or distortion of competition; the Act also prohibits the abuse of a dominant position. The BBC will only be caught under the Competition Act 1998 if it is an ‘undertaking’ (an entity carrying on an economic activity), and the BBC will not in every case be acting as such. Although it is a difficult exercise to determine whether a public sector body should be regarded as an undertaking in any given context²⁸, it seems likely however the BBC would be considered an undertaking in more contexts than not, due to the ‘business-like’ nature of many of its activities²⁹.

It is also apparent from the case law that it is irrelevant whether an organisation has a profit motive³⁰. This suggests that the public service arm of the BBC may also be properly considered an undertaking, and the BBC has in fact been a party to a notification under the Competition Act on at least one occasion³¹.

Intra BBC Agreements May Not Be Caught

Article 81 EC and Chapter I of the Competition Act 1998 only apply to agreements *between* undertakings (Article 81 will apply if the agreement may have an effect on trade between member states). There will be no agreement between undertakings if the BBC and its various subsidiaries are viewed as a single economic entity³². Whether this is the case depends on the level of control and influence inserted by the BBC over the subsidiaries.

If the BBC commercial subsidiaries are simply established to allocate particular tasks and have no real autonomy, the BBC is likely to be a single economic entity. It seems that, on balance, this is the better view as the commercial activities must be consistent with, and supportive of, the BBC’s core purpose as a public service broadcaster.

Consequently, to the extent that the BBC commercial subsidiary engaged in anti-competitive practices, this could only be caught under Article 82 EC or Chapter II of the Competition Act 1998, which prohibit the abuse of a dominant position. (As with Article 81, Article 82 will apply if the abusive conduct may have an effect on trade between member states).

²⁸ *Public sector bodies and the Competition Act 1998: A guide to the extent to which public sector bodies may fall within the scope of the prohibitions in the Competition Act 1998*, Office of Fair Trading (2000)

²⁹ See especially *BetterCare Group Limited v the Director General of Fair Trading* [2000] CAT 7.

³⁰ See eg Cases 209/78 etc *Van Candlewick –v- Commission* [1980] ECR-3125

³¹ *Attheraces* notification, CP/1442/01 21 November 2001.

³² Case 34/87 *Corinne Bodson –v- Pompes Funebres Des Regions Liberees SA* [1988] ECR-2479. The Court of Justice considered that Article 81(1) would not apply if the undertakings “*form an economic unit within which the subsidiary had no real freedom to determine its cause of action on the market, and if the agreements or practices are concerned merely with the internal allocation of tasks, as between the undertakings*”.

Possible Exclusion of the BBC from Provisions of the Competition Act 1998

Even where the BBC is regarded as an ‘undertaking’ in a particular context, the force of the Competition Act *as a whole* would be excluded if the BBC were performing services of general economic interest, and the application of the competition rules would obstruct the performance of the entrusted tasks.

To benefit from the exclusion OFCOM would need to be satisfied that:

- the BBC has been “entrusted” with a service by a public authority; this appears relatively easy to satisfy.
- the BBC is providing a service of “general economic interest”; there seems little doubt that public service broadcasting by the BBC would be classed as a service of general economic interest. In relation to non-PSB activities, the test would be whether it is a service that the public authorities consider should be provided in all cases, whether or not there is an incentive for the private sector to do so.
- the application of the Competition Act ‘would obstruct the performance of the task entrusted to the undertaking’. This is a key element of the exclusion. EC jurisprudence has interpreted this as requiring undertakings seeking to benefit from the exclusion to demonstrate that the granting of the exclusion is the least restrictive means of ensuring the undertaking can meet its objectives.

However, despite this ostensibly restrictive approach, the European Court of Justice has allowed the competition rules to be disapplied to overt cases of cross subsidisation, where a service was argued to be one of general economic interest.³³ Depending on its application in practice, therefore, this general exclusion might afford the BBC something of a ‘safe harbour’.

3.2 The BBC's Fair Trading Commitment

BBC services are also “regulated” under the terms of a Royal Charter (the “Charter”) and a separate agreement with the DCMS (the “Agreement”). Compliance with the Charter and Agreement is monitored by the BBC Board of Governors, the members of which are appointed by Government and who serve a fixed term.

Under the provisions of the Charter the BBC may provide public services such as BBC1, BBC Online and BBC Radio2, and commercial services, including magazines, advertising funded websites, videos and DVDs, as well as commercial television channels, at the discretion of the Secretary of State for Culture, Media and Sport.

Acknowledging the risk to competition of the BBC using its privileged access to public funds to unfairly benefit its commercial activities, the Charter requires compliance with the so-called Fair Trading Commitment (the “Commitment”).³⁴ Under the Commitment, all BBC commercial activities must:

- be linked to and consistent with the programme purposes of the BBC;
- reflect the same values of editorial quality and integrity;
- plainly arise from and support BBC programmes;
- add to viewer and listener choice;
- comply with legal and regulatory requirements;
- offer the prospect of generating significant funds for reinvestment in BBC programmes

³³ Case C-320/91 *Corbeau v. Belgian Post Office* [1993] ECR I-2533.

³⁴ The Fair Trading Commitment is based on very high-level principles, with the practical implementation of these principles contained within the BBC’s Commercial Policy Guidelines.

As a general principle, the Commitment requires that the BBC will not use licence fund or grant-in-aid³⁵ either to subsidise or to support operating losses made by the activities. This requires that there is an arm's length relationship between commercial activities and the rest of the BBC, that there is transparency in commercial dealings, and that fair pricing exists in relationships between the commercial activities and the rest of the BBC. The BBC's Communications Policy sets out the process required for compliance with the Commitment.

Fair Trading Compliance Process

Compliance with the Commitment is audited annually by an independent auditor, with their opinion published in the Annual Report. In practice the auditors audit the effectiveness of the compliance *process*, ensuring that fair trading advice is sought by staff involved in commercial activities when it is appropriate to do so. The auditors are not required to report on the quality of the advice given and do not advise substantive on commercial or competition issues unless their input is specifically requested.

Corporate Structure and Regulatory Concerns

The Charter sets out some basic requirements for the relationship between the commercial activities and the rest of the BBC. Fundamentally, the Commitment requires that the BBC's commercial activities must compete fairly, without access to licence funds. Clearly, use of licence funds to support the BBC's commercial activities would almost certainly amount to a State Aid. Although under the Commercial Policy Guidelines Public Service divisions are allowed to operate commercially using marginal capacity, the vast majority of the BBC's commercial revenues are earned by wholly owned limited liability subsidiary companies. The limited liability status of the subsidiaries is intended to minimise financial risk to licence funds, with the accounting and managerial separation of each of the subsidiaries from the publicly funded BBC aimed at ensuring that the subsidiary receives no unfair financial (or other) benefit as a result of its parentage.

The Commitment requires that the commercial subsidiaries are treated on an arm's length basis from the rest of the BBC and receive no unfair treatment in their commercial dealings with the BBC. However, as described in some detail in section 5, the conflicting incentives of the BBC, given the pressure on it to increase its commercial revenues, and the practical difficulties of ensuring fair treatment during commercial negotiations, which are in practice intragroup transfers, has raised doubts amongst several parties (most notably PACT, IPC Magazines and ITN) about the effectiveness of the current regulatory framework. Such concerns may be mitigated by the requirement³⁶ that the BBC adopt a code of practice on its relations with independent producers. However, it is striking that the measures announced by the Secretary of State bear less hard on the BBC than on other UK terrestrial broadcasters and apply only to television programme supply.

4. Licence Fee-Financed Activities

In this section we examine competition issues which arise in relation to public service broadcasting activities funded by the licence fee.

4.1 Public Service Broadcasting

The term "public service broadcasting" (PSB) is notoriously elastic, but the need for definition is clear. It is required for specific formal purposes, like determining which services are to enjoy "must carry" privileges under the EU Universal Service Directive³⁷; for the more general internal

³⁵ BBC World Service and external services are funded by the Foreign and Commonwealth Office through grant-in-aid.

³⁶ Announced by the Secretary of State on 15 January 2003.

³⁷ Directive 2002/22/EC of the European Parliament and of the Council on universal service and users' rights relating to electronic communications networks and services [2002] OJ L 108/51.

management purposes indicated by the Davies Panel³⁸; and for determining which activities of public broadcasters might benefit from escaping the application of the competition rules, as described above.

The Davies Panel, reporting on BBC funding in 1999, acknowledged the problem of definition and then ignored it – stating that though it could not “offer a tight new definition of PSB” the panel was confident they “knew it when we saw it” (Davies 1999: 10). The ITC is not much more helpful. It has defined PSB as “all things to all people at least some of the time”. Subject to the qualification that PSB is marked “with a strong emphasis on extending public knowledge, tastes and interests. It is the essence of social inclusion” ITC (2000: para A3).

More recently, the new Communications Act (2003) presented an opportunity to define PSB. However, rather than define public service broadcasting, the Act distinguishes between three different classes of broadcaster, the first two of which are classified as public service broadcasters. Each class is subject to differing degrees of regulation by OFCOM.

The BBC and S4C;

- Public Service Broadcasters – i.e. Channels 3, 4, 5;
- Providers of licensable content services, i.e. satellite and cable services.

The Act identifies the BBC and S4C as public service broadcasters (cl 256(12)) so that they are included in any “must carry/must offer” provisions relevant to the EU Universal Service Directive. The most onerous regulation by OFCOM is reserved for class 2 – Channels 3, 4 and 5. OFCOM has jurisdiction over the BBC and S4C, but only in respect of privacy and fairness issues (i.e. as presently specified in Part V of the 1996 Broadcasting Act), the three tiers of content regulation, and the independents’ quota which is currently a charge on the Director General of Fair Trading (s186 Broadcasting Act 1990). Providers of licensable content services (i.e. satellite and cable broadcasters) will be subject to negative content standards but not positive content requirements.

The most important provisions of the new regulatory regime that will apply to the BBC are to be defined outside the Act, as set out in a new draft Agreement between the BBC and the Secretary of State for Culture, Media and Sport. Essentially, the draft agreement mirrors the PSB requirements in the Bill.

The Communications Act offers a very slim statement of public service broadcasting remits. The ITC described these, at the Bill stage, as so imprecise as to make it difficult to know what the Government wants to achieve.³⁹ Moreover, the remits, such as they are, are not linked to an analysis of market failure. So there is no way of knowing how much of the PSB remit will be discharged by commercial providers and how much needs to be done by PSB broadcasters.

The absence of a satisfactory definition is a clear impediment to the development of a fully justified view of the appropriate arena for use of the licence fee. In our view, however, definition of PSB must ultimately be a political decision of the Government. Even when the decision about scope has been made, there will be a variety of ways of achieving PSB objectives, characterised by different levels of opportunity for the operation of a competitive process. Allocating all licence fee revenue to a single public service broadcaster gives that broadcaster considerable market advantages. The combination of large and predictable revenues and an output maximising objective creates conditions in which it is

³⁸ According to the Davies Report “[T]oo often, the BBC in effect behaves as if as if public service broadcasting is everything the BBC choose to put out” (Davies 1999: 391).

³⁹ ITC, *Memorandum to the Joint Scrutiny Committee on the Communications Bill*, 23.4 2002. Formerly available at www.itc.org.uk but due to the abolition of the ITC in consequence of the establishment of Ofcom on 29.12.2003, the ITC website no longer exists and this data is no longer accessible via the ITC site.

entirely possible that competition will be distorted in the whole broadcasting value chain, as well as in related activities.

Despite the inevitably political nature of decisions about the scope for BBC's licence fee-financed activities, certain safeguards are practicable, desirable, and should be achievable in that they non-political. These relate particularly to the expansion of the BBC's activity into new areas, although the equivalent considerations should also apply in relation to existing activities (see 4.3 below for discussion).

4.1 Approvals Process for new PSB Services

The approvals process for new BBC public services was revisited as part of the 1999 licence fee settlement (which guaranteed the BBC revenues rising at RPI plus 1.5% each year to 2006), and two major changes were made to it. Previously, consent for a new service could be granted by the Secretary of State immediately following approval by the BBC Board of Governors, whereas under the revised arrangements, the proposals are subject to public consultation. Second, there is an obligation on the BBC to persuade the Secretary of State that the proposed service would not have a significantly adverse impact on the market. The latter constraint was the reason given for the Secretary of State initially withholding consent for BBC 3 TV, when approval was recently given to other new digital TV and digital radio services. Subsequently, after review by the ITC, consent was given for BBC 3.

Consents granted by the Secretary of State are based largely on general principles covering what the service will include. Consents are typically very broad in scope and allow the BBC considerable flexibility to introduce revisions and enhancements under the umbrella of the consent, by-passing the formal consultation process. For example, the BBC has recently introduced an Internet search engine as part of the public service BBCi (formerly BBC Online). Although this 'new' service may be covered by the existing consent, it is unlikely to have been considered when the consent for BBCi was granted in 1997. The extensive on-air promotion of the search engine must make the BBC's rivals in this market envious. It remains to be seen whether providers of rival search engines will mount a challenge to the BBC's entry to their market. It will certainly be interesting to see whether the range of services now offered on BBCi (including interactive games and mobile services) becomes an issue during the Government's review of the BBC's online activities announced in December. It also remains to be seen whether the review will incorporate third party views.

Once a consent is granted the BBC has considerable flexibility in how it interprets the consent. For example, the provision of BBC News services to mobile phone users is operated under the consent for BBC Online, despite the fact that this particular service would not have been considered at the time of the original consent. Similarly, the BBC offers interactive games, logos and ring tones under the umbrella of the Online consent. It is of interest to note that the BBC began its news to mobile services as a commercial venture, before realising that was not profitable. The service has since been re-launched as a public service without any public consultation, as the BBC believes the service is covered under the terms of the Online consent. Plans are currently afoot to translate BBC World, the loss-making commercial news channel, from BBC Worldwide to a division funded by non-commercial sources.

Educational publishers and IT suppliers have campaigned vociferously against the BBC's proposal to launch an extensive Internet based curriculum support service, aimed at teachers and pupils, using £150 million of licence funds. While the BBC argued that its digital curriculum service will only cover a subset of subjects, the publishers alleged that this will cost the U.K. publishing market £400 million and force a number of the BBC's rivals out of the market, reducing competition in an educationally and economically important sector. The Secretary of State's grant of approval (of 9 January 2003) for the BBC's proposals means there is likely to be a significant impact on the structure of the market. However, in spite of requirements for the BBC to spend 50% of its commissioning budget in the commercial sector, to report annually and to submit to review after two years, it is not

clear whether the structural consequences and the impact on long term competition in the market have been taken into account in the approvals process. However, there is no requirement for the Secretary of State to seek the views of relevant competition or regulatory authorities.

4.3 Recommendations

We therefore recommend as amendments to the approval process for new BBC services described above, the following:

- that the Government specify in more detail the criteria to be applied in determining whether the BBC should be allowed to undertake an activity;
- that the BBC's Agreement should be constructed in a way which give a firmer steer in relation to the range of BBC activities for the full duration of the Agreement; in other words, it should be more forward-looking and less subject to amendment in the course of its life;
- that the existing practice of giving umbrella authorisations should be abandoned;
- that in the case of a material change in the scope of the BBC's licence fee-financed activities, OFCOM should prepare for the Secretary of State a public report indicating the likely impact on existing and potential competitive suppliers of the BBC's entry into a field of activity.

The linkage between the first and the fourth of these recommendations is clear. It is likely that the justification for the BBC's entry into new activities will be, at least in part, a market failure. (This does not preclude other motives such as providing a universal service, but such objectives can often be achieved in other ways than via a licence fee-financed public provider.)

5. Competition Aspects of the BBC's Commercial Activities

Turning to the linkage between the BBC's commercial and its PSB activities, we summarise below five areas of BBC activity that serve to illustrate the weakness of the current regime and provide examples of where independent *ex ante* regulation may be better equipped to address regulatory concerns. The examples we list cover both commercial and public service activities.

5.1 Intellectual Property (IP) Exploitation

The BBC's public service IP (ie content) is commercially exploited through the BBC's Commercial Agency, part of the public service. The Commercial Agency licenses to third parties the IP for exploitation.⁴⁰ Unsurprisingly, the vast majority of rights are licensed to BBC Worldwide. Under the Commitment, the BBC is required to ensure that BBC Worldwide pay a fee for each licence that is fair and is consistent with market prices for similar rights. In an attempt to ensure that BBC Worldwide pays a fair market rate for rights it acquires, the BBC periodically benchmarks the prices paid by BBC Worldwide against prices paid in the external market for content rights. Benchmarking prices for IP is difficult. In addition to the practical difficulties of obtaining reliable price data, it is not always clear what should be benchmarked. Moreover, given that this IP is by its nature not a homogenous product, it is a moot point whether benchmarking is an effective tool for ensuring that BBC Worldwide pays a market rate for acquired rights. Yet if BBC worldwide are receiving rights for less than they would be worth in an open market, this could distort competition and may amount to a State Aid.

There are other instances where the BBC may face powerful incentives to favour BBC Worldwide unfairly. For example, it has been alleged that where rights are offered to third party distributors, BBC Worldwide benefits from a preferred partner status that allows it to know what rival distributors have bid for exploitation rights, when the same does not operate in reverse. In its *Courage to Compete* report PACT complained that the BBC's relationship with BBC Worldwide meant that independent

⁴⁰ Rights can either be acquired *ex ante* through investment in programmes or *ex post* through purchasing a licence.

producers did not get fair value for the commercial exploitation of their rights. Even where the BBC is willing to receive bids from other distributors, it is not certain that there is a level playing field. PACT have also alleged that BBC Worldwide executives are too closely involved in the commissioning and production processes, giving them an unfair informational advantage over other potential distributors.

An alternative approach to exploitation could be to require the BBC to operate a genuinely level playing field, with regular tendering exercises that would be independently audited. A similar approach is taken to procurement exercises in the NHS.

5.2 Purchasing Production Facilities

Similar concerns arise in the BBC's relationship with its business to business subsidiaries⁴¹, which supply the BBC with production facilities (e.g. studios, OB units, IT support and playout services). When purchasing these facilities from its subsidiaries the BBC's Royal Charter requires that the BBC pay a fair market rate. Again, occasional benchmarking exercises are relied upon to ensure that the BBC is paying a fair market price for the services that it receives and is not subsidising them unfairly through overpayment. Particular difficulties arise in the benchmarking of prices for production facilities due to the lack of price transparency. Published rate cards are rarely adhered to, with each supply agreement individually negotiated, and volume discounts are commonplace.

Producer Choice, an initiative introduced by John Birt to improve efficiency, places additional pressures on the BBC's B2B subsidiaries and raises additional questions of conflict for the BBC. Producer Choice requires that each programme unit source the necessary facilities from the best value supplier. The initiative is credited both with driving down BBC costs and for encouraging the growth of a significant facilities market in the U.K. (primarily in London). The BBC faces a risk that the best value supplier may not be one of the BBC subsidiaries. While the Charter requires that the subsidiaries do not benefit unfairly from their parentage, there is some doubt as to whether in practice the BBC is fully incentivised to be as demanding a parent as a fully commercial company. If this is the case, it may be possible for the subsidiary to accept a lower margin on a contract than would be viable for a rival firm. In practice, this is difficult for the Governors to regulate. Similarly, it would be possible for the BBC to pay above the market rate to one of its own subsidiaries as a hidden subsidy. This could amount to an unfair use of State Aid and distort competition in the subsidiary's markets.

Again the BBC could be required to openly tender for its production facilities in the same way that other public services are required to, with the process and the outcome independently audited.

5.3 Incorporation of Commercial Subsidiaries

Incorporation of a commercial activity as a limited liability company requires that a number of regulatory hurdles be overcome. First, the management must put a business plan to the BBC Board of Governors for approval. Secondly, Governors will normally require that the Fair Trading Compliance Committee (FTCC) has addressed the fair trading issues. Fair trading matters would typically include valuing the transfer of assets (including IP) and making sure proper contracts are in place to cover the supply of services to the BBC. Finally, a request for consent for establishing the subsidiary is made to the Secretary of State. Unlike the consent process for a new public service, there is no obligation on the Secretary of State to consult publicly on the request. Nor is there a requirement that the BBC demonstrate that the new subsidiary have a minimal market impact.

Given the scale with which the BBC has entered commercial markets, it is surprising that there is no formal obligation on the Secretary of State to seek the views of the competition authorities before granting a consent – the Secretary of State has the option to seek their opinion, but is not obliged to do

⁴¹ BBC Resources, BBC Technology and BBC Broadcast.

so. For example, the incorporation of BBC Broadcast has created a firm with significant presence in the markets for playout, access services and creative services, significantly altering the structure of those markets⁴² without there having been any consideration of the incorporation by a competition authority or regulator.

5.4 *On-air Trailing of Commercial Products*

As part of the 1999 licence fee settlement, the Secretary of State set exacting targets for the BBC to raise an additional £1.1 billion over four years. This is to be achieved through a combination of cost efficiencies and increased returns from the BBC's commercial activities. Trailing of commercial products on air is a valuable means of advertising to audiences the availability of magazines, books, videos and other products that support particular programmes. Although the BBC does not sell its air time for advertising, it does make air time available for the promotion of its own commercial products. Airtime must only be made available for trails that are editorially justified. If airtime was made available for the commercial benefit of BBC Worldwide, this would amount to a State Aid.

The BBC trails products on-air according to undertakings given to the Office of Fair Trading (OFT) in 1990, following a Monopolies and Mergers Commission report into magazine trailing on the BBC and ITV. The BBC is permitted to trail subject to certain conditions, including:

- it can use an average of seven minutes per week of air time to trail magazines across its television services.
- it can only use still trails with a voice over; and
- reference must be made to other available products where appropriate.

The BBC reports on its compliance with these undertakings in its Annual Report. It is not known whether the OFT has reviewed the undertakings, but given the pressure on the BBC to increased commercial revenues and the somewhat dated nature of the undertakings they refer only to magazines and to trails on BBC1 and BBC2, ignoring the other channels) it might considered whether the undertakings continue to be sufficient. In particular, it is a moot point whether the BBC should be free, under these undertakings, to trail seven minutes for magazines across BBC1 and BBC2 and face no restrictions for other products or for trailing on other BBC channels.

5.5 *Public Service/Commercial Split*

BBC channels typically share fixed production costs, with BBC News being funded out of the budgets of all BBC channels (TV, radio and online) that carry news services. As they are all publicly funded, cost allocation in this case raises no competition or regulatory problem. However, where the BBC is sharing costs between public service and commercial channels, the issue of cost allocation is an important one, as inappropriate allocation could amount to a subsidy of the commercial service. For example, how are costs to be allocated when a programme is broadcast both on the public service channel, BBC News 24 and on the BBC's commercial news channel, BBC World?

Richard Lambert, formerly Editor of the "Financial Times" in his review of BBC News 24 found that the BBC was properly attributing common costs to BBC News 24, commenting that "News 24 is paying its share of the Director General's limousine" (Lambert 2002: para 6.12). Though he also found that "licence fee payers and the BBC's competitors have to take too much on trust" (Lambert 2002: para 6.20). Accordingly, he recommended that "The BBC should publish broad details of the financial relationships between its subsidised and commercial news activities" (Lambert 2002: para 6.21) and that future reviews of the BBC's digital activities should "be made the responsibility of OFCOM" (Lambert 2002: para 8.12).

⁴² Prior to incorporation, BBC Broadcast was not permitted to engage in large scale supply of services outside of the BBC Group.

A similar regulatory challenge arises where the public service has fully funded the production of news content that is then licensed to BBC World. Again the BBC relies on benchmarking to ensure that BBC World pays a fair market price for the content. Although the marginal cost of licensing the content would be negligible (almost zero), would the BBC licence the rights to a third party on a marginal cost basis? If not, then BBC World is not operating on a level playing field, where BBC World receives content on that basis.

An additional regulatory question is whether it is appropriate for the BBC to rely on benchmarking itself against commercial broadcasters. For commercial broadcasters, such intragroup transfers are merely for management accounting purposes, but for the BBC such financial transfer must represent the value of the content transferred otherwise there is a risk of a State Aid being granted to the BBC commercial channel.

Given the opaque nature of many of the markets in which the BBC operates, and the conflicting incentives faced by the BBC as a public service broadcaster and owner of commercial businesses, the application of the existing compliance processes, through benchmarking and other methods, is not sufficient to ensure fair trading.

6. Policy Responses

The key issue here is whether there is any special feature of the broadcasting market or of the role of the BBC within it that makes it desirable to enact special legislative measures, in addition to generic competition law, to deal with situations which may occur including those of the type discussed in the provisions. See below.

We observed at the outset that the scale of the BBC and its access to licence fee finance introduces a major structural abnormality in the broadcast industry. However, we have not addressed the question of peculiar features of the industry as a whole.

The broadcasting industry shares many features in common with other network industries: economies of scale; economies of scope; high 'first' copy costs and zero (or very low) marginal cost of additional consumption.

In a recent speech the Director General of Fair Trading pointed to a further cause for concern – co-existence within broadcasting different methods of revenue generation. He also noted that 'broadcasting is a multi-layered industry, in which market power at one level of the supply chain may have far-reaching effects at other levels. All this is relevant for analysis of competition in the sector'. He went on to make the remark quoted at the start of this paper, about 'the increasing tendency of the BBC to launch services or markets beyond its traditional public service remit (which) could raise difficult competition issues' (Vickers 2002: 4).

In our view, it is this final point which raises the most acute questions about *ex ante* interventions. By way of analogy, the EU has recently adopted legislation for electronic communications services (excluding content) which authorises *ex ante* regulation in markets where dominance is found (exercised by a single firm, by firms jointly, or leveraged from the vertically related market). The criteria for *ex ante* intervention⁴³ are, *inter alia*, the presence of persistent barriers to entry, limited prospect of opening up of the market and demonstration of the comparative advantage of *ex ante* regulatory intervention over *ex post* competition law. We are not persuaded that these conditions apply to the broadcasting industry in general and hence do not favour *ex ante* intervention across the board. But it remains an open question as to whether the BBC's position requires some special intervention.

⁴³ Commission Guidelines on market analysis and the assessment of significant market power under the Community regulatory framework for electronic communications networks and services [2002] OJ C 165/6.

In what follows, we will consider the scope for structural intervention, the ability of competition law to deal with competition problems identified and the form and appropriateness of *ex ante* regulation.

6.1 Structural Remedies

The potential problems referred to in earlier sections include predation, refusal to supply, cross subsidy, abuse of buyer power and failure to trade fairly. Many of these potential abuses are motivated by the desire to leverage dominance from one market into another. Such problems can in many cases be prevented by some form of structural separation. Separation options have been widely rehearsed in the utilities, where distinctions are made between accounting separation, legal separation through incorporation of subsidiaries and structural or ownership separation (see OECD 2002). Except in cases where separation imposes heavy transaction costs (such as problems in co-ordinating investment decisions) separation is a good way of countering discrimination.

The BBC has gone some way down the route of legal separation, through the separate incorporation of BBC Broadcast, BBC Technology, BBC Worldwide and BBC Resources. As in all such cases, questions are inevitably raised as to whether the notionally separate managements do operate with full independence in their own sphere of competence, or whether they have an eye to the impact of any decisions on the group overall. Partial ownership separation may be adequate to achieve the benefits of independent decision taking and allow the advantage of some synergies to be retained.

Davies (1999) in his report into the funding of the BBC proposed, some radical separations – which are yet to be fully implemented. It recommended the sale of the majority of BBC Resources and the injection of significant private capital into BBC Worldwide. This would create conditions more similar to those operations in ITV, where the ITV's networking and scheduling process is separated from programme production by individual ITV companies.

It is a conventional wisdom among those concerned with competition policy that structural rather than behavioural remedies are greatly to be preferred. We share this view and believe that ownership separation of a number of BBC incorporated companies should be considered. Alternatively, appropriately rigorous regulation of the interface between separate activities may encourage the BBC itself to see the benefit of ownership separation as happened in the case of British Gas.

6.2 The Adequacy of Competition Law

In the language of competition law, the objectionable behaviour identified above fall into the following categories:

- *monopsony* (PACT's complaints in relation to the acquisition of independent producers' intellectual property);
- *excessive pricing* (in markets where the BBC might attain a dominant position);
- *refusal to supply* (where the BBC does not make programming available to its channel competitors);
- *predation* (where rivals are driven out of markets by loss-making prices);
- *undue preference* for an associated company (where services such as programme making or resources are bought from internal sources or an associated company in contravention of fair trading obligations);
- *cross-subsidy* (where all or part of the costs of a product are allocated to another product);

We have argued above that the key structural feature of broadcasting markets which may justify *ex ante* regulation arises from a combination of the scale of the BBC, its access to licence fee income and its participation in a very large number of potentially competitive markets. We have suggested above possible ways of tightening the procedures for the BBC's movement into new services where those services are funded by the licence fee. In this section the focus switches to commercial services.

If the source of the problem is the co-existence of a licence fee and commercial activities, then the case for *ex ante* regulation is likely to be strongest in cases which arise there. For that reason we do not see a need for specific intervention (beyond competition law) where the BBC is potentially in a position to exercise market power as a buyer or seller. This rules out the need for intervention in the relationship with independent producers (which has already been the subject of competition investigations) or cases where the BBC may, prospectively become dominant in a particular market (for example, that for subtitling). This conclusion differs from that of the Independent Television Commission which, recently recommended (see ITC 2002) that OFCOM have statutory powers to, for example, require the unbundling of rights and supply indicative tariffs for primary rights.

Cross-subsidy, predation and self-preference (departure from fair trading obligations) are in a different category. They are forms of potentially anti-competitive behaviour for which the BBC has both the means – the licence fee – and the motive – output maximisation. They are also types of behaviour which are exceptionally difficult to detect without the ability on the part of the regulator or competition authority to build up information and expertise.

6.3 Function of Ex Ante Regulation

One possible way forward, not adopted in the Act, was to introduce *ex ante* regulation that might do four things:

- it should prevent the BBC from cross-subsidising its commercial subsidiaries;
- it should prevent the BBC from showing undue preference towards its commercial subsidiaries;
- it should require the BBC to furnish the information which OFCOM requires in order to enforce these prohibitions: this information is likely to include regular reports, such as quarterly or annual accounts, responses to particular questions which may arise from time to time and – in some cases – the submission of regular detailed reports where an infraction has been found, or is reasonably believed to have occurred;
- it should require the BBC to notify OFCOM, confidentially, of its commercial plans ahead of their implementation.

These requirements are in some ways akin to licence conditions imposed upon telecommunications operators, which prohibit the showing of undue preference and prohibit a cross-subsidy. They should be backed up by a system of penalties and be subject to appeal.

It might be considered that since competition law already catches cross-subsidisation and discrimination, there would be nothing to gain by bringing these forward into an *ex ante* regime. The advantage lies, however, in the fact that it would not be necessary to show in each case that the BBC met all other criteria for the application of the Competition Act (or indeed that the activity was not excluded from coverage of the Act as a whole, in the way discussed above).

6.4 Conclusions

As it seems clear that the *ex ante* route has not been taken, the burden of regulation will fall upon OFCOM using its concurrent powers under the Competition Act 1998. To exercise this properly, and to identify more subtle forms of discrimination, it will have to develop knowledge and expertise in the transactions noted above. Its experience in these matters will prove valuable in making decisions, in due course, about structural separation of the BBC.

It is important to recognise the danger of over-regulation, which may deter competition and innovation on the part of the BBC. However, the peculiarities of BBC funding (its source and scale) create exceptional risks that private sector initiative and investment may be discouraged. This will limit diversity and discourage investment in broadcast markets, diminishing competitive pressure on the BBC itself. Equally worryingly, the infection may spread to related markets – especially on-line

markets – where the rationale for licence fee funding of a single organisation is, at best, threadbare. Unfair competition here can have major repercussions for UK investment, jobs and exports. It is vital that the Government and OFCOM work together to refine the BBC's remit, and that OFCOM be in a position to apply the Competition Act 1998 vigorously. These measures are needed to encourage investment and innovation in broadcasting both by the BBC and its competitors in the UK and from overseas.

The BBC's Royal Charter expires in 2006. The Charter Review, which the Government has promised and to which Ofcom will contribute through the review of public service broadcasting which it is charged to undertake in 2004, provides the next opportunity to address issues of BBC governance.⁴⁴ It will be clear from our analysis above that we do not believe the public interest is likely to be well served by the BBC's continuing self-regulation and the view that the BBC should fall more fully under the jurisdiction of Ofcom. However, we do not believe that competition and content regulation can sensibly be separated or that formal accountability to Ofcom, rather than to the BBC's Governors, will be sufficient to ensure that the BBC serves the public interest in broadcasting. Strengthened powers of *ex ante* regulation will be required, because the BBC is not just an ordinary object of competition law. The current fair trading rules and conditions for approval of new services do not adequately reflect the public's interests; this points to a more exacting regime of competition regulation on the lines above indicated.

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⁴⁴ At the time of writing, it was neither clear how Charter Review would proceed nor how Ofcom itself will function. Integration of five hitherto separate agencies, each with distinctive cultures, traditions and remits, may prove challenging. Moreover, none of the constituent parts of Ofcom (with the qualified exception of the Broadcasting Standards Commission) has had more than a tangential regulatory responsibility for the BBC and, despite the statutory mandate to review public service broadcasting, Ofcom has scant jurisdiction over the BBC.

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