Regulatory Financial Review 2017

BT's commentary on the Regulatory Financial Statements

31 July 2017

Disclaimer

This document contains BT's commentary on the 2017 Regulatory Financial Statements (RFS). It reflects BT's own view and interpretation of the results presented in the RFS and has been produced without any involvement from Ofcom. BT has chosen to make this commentary available to assist readers of the accounts. The content of this document and its publication do not form part of BT's regulatory reporting obligations arising from market reviews or SMP conditions.

1.0 Introduction

This document explains the year on year movement in the markets where we have Significant Market Power (SMP). It should be read in conjunction with the 2017 Regulatory Financial Statements (RFS).

For certain services, in markets where we are deemed to have SMP, Ofcom has imposed charge controls in the form of CPI-X (or RPI-X) annual price reductions. The charge controls determine the maximum prices we can charge over a three year review period and are set such that, if we meet the cost efficiency targets set by Ofcom, we would earn the expected cost of capital on those services by the end of the period. In other words, we would earn the returns expected by Ofcom (for example in the Business Connectivity Market Review (BCMR) statement published on 28 April 2016, the relevant pre-tax nominal Weighted Average Cost of Capital (WACC) was 8.8% for copper access components and 9.8% for other network components).

Readers should note that for the purposes of assessing our returns in setting charge controls, Ofcom has requested the adjustments set out in Appendix 3 of the 2017 RFS (Adjusted Performance Summary).

In order to incentivise long-term efficiency gains, we are not required to further reduce prices during the charge control period if we exceed the efficiency targets (for example by delivering greater cost efficiency or higher volumes than expected). But equally, we cannot increase prices above the cap if we do not achieve the efficiency targets determined at the outset. Our actual Return on Mean Capital Employed (MCE) on these services may thus vary from the target envisaged by Ofcom and this is an accepted and established feature of the regime which has proved effective in driving efficiency incentives (in telecoms and other regulated sectors) and delivering benefits for customers.

Ofcom may set a "glide path" to the final year of the control period such that prices move smoothly towards the target over the earlier years of the control, rather than re-basing prices abruptly to costs in the first year of the control (although in some cases both approaches are used with a partial adjustment towards costs in the first year followed by a glide path thereafter). Glide paths are used to encourage greater efficiency (particularly at the end of the review period) by allowing some of the efficiency benefits to be kept beyond the start of the next period, balanced against the need to pass the benefit of price reductions to customers in a timely manner. The expected returns in the first two years of the control period may therefore exceed that of the third and final year.

Ofcom may also make adjustments as part of its charge control determination to reflect life cycle considerations, particularly for charge controlled legacy products which utilise almost fully depreciated assets, but where there are economic reasons not to price in line with low accounting costs because this may impede efficient migration and investment decisions. In these cases, a Hypothetical Ongoing Network (HON) model may be used to assess appropriate asset lives and the relevant depreciation charges, especially where technology and migration to new services are important. Ofcom has used the HON model to set charge controls which provide efficient network investment signals.

For around one third of services by revenue, where we are deemed to have SMP, Ofcom imposes other forms of price regulation, principally a requirement to price on "fair and reasonable" terms and/or a "safeguard cap" (where we may not increase prices from a pre-determined level). For such services, Ofcom does not specify a target return on capital on a Fully Allocated Cost (FAC) basis (assuming the achievement of Ofcom's efficiency targets).

Put simply, much of this regulation is specifically designed to serve Ofcom's objectives; in particular its objectives to promote investment delivering benefits to customers in the form of new services and greater choice which must be weighed against the short term benefits from price reductions. BT's performance in specific markets must be considered in this broader context.

Reasons for choosing a form of control other than a charge control are varied and may include:

- Services using legacy technology where price reductions would disincentivise migration to newer technology and discourage investment in such technology;
- Services which are prospectively competitive and hence a full charge control would be disproportionate; and
- Services, the provision of which is constrained by the existence of a competing product (i.e. a product which acts as a partial or full substitute for many customers) which is subject to regulation (a so-called "anchor" product).

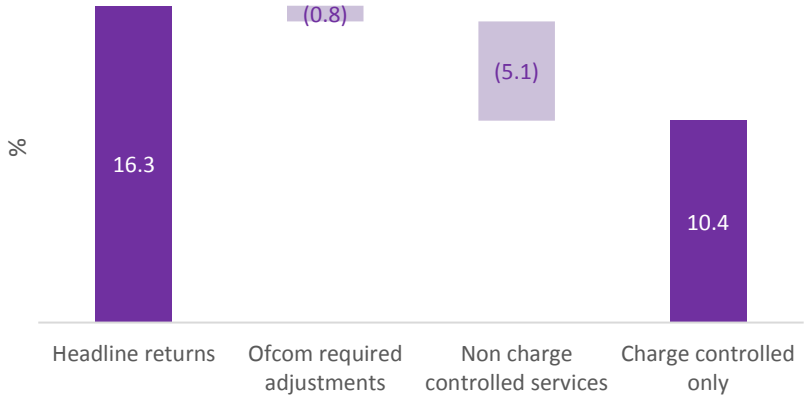
It is important to note that the Return on MCE is a snapshot of our returns in a particular year and also may not reflect the returns a service will make on a lifetime basis.

More generally, the Return on MCE is sensitive to accounting depreciation applied to assets which may not reflect the true economic value of those assets. In particular, for legacy and early life assets, the accounting value will not align with the economic value and therefore accounting returns will not capture the true economic profitably of the asset or the value of the asset in steady state. Finally, it should be noted that not all of the services underpinning the returns described in detail below are sold in significant quantities to external customers.

2.0 Total SMP markets adjustments are:

Pre-Tax Return on MCE	**2016/17**	2015/16 Restated
Total SMP markets – Performance Summary	**16.3%**	**17.9%**
Adjustments as set out in Appendix 3 in the RFS	(0.8%)	(1.2%)
Total SMP markets – Adjusted Financial Performance Basis	**15.5%**	**16.7%**
Adjustment to exclude returns from services without charge controls	(5.1%)	(3.6%)
Charge controlled services – Adjusted Performance Basis	**10.4%**	**13.1%**

2016/17 Total SMP Pre-Tax Return on MCE



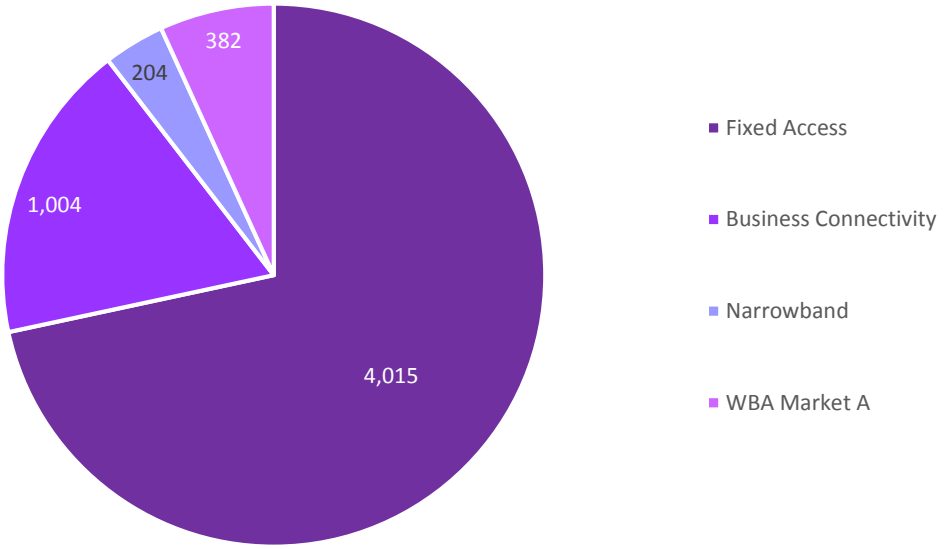
Price cuts from 1 April 2017 of circa £110m per annum have been made to business connectivity services under charge controls imposed by the BCMR statement of 28 April 2016. To give an illustration of the expected impact of these changes on our future returns, we note that the pre-tax return on MCE of charge controlled services would have been approximately 1.2% lower (i.e. circa 9.2% on the adjusted performance basis as reported above) if the reduced prices had been in place in 2016/17.

We give details of the adjustments by market grouping on the following pages.

2.1 2016/17 SMP Markets Total Revenue:

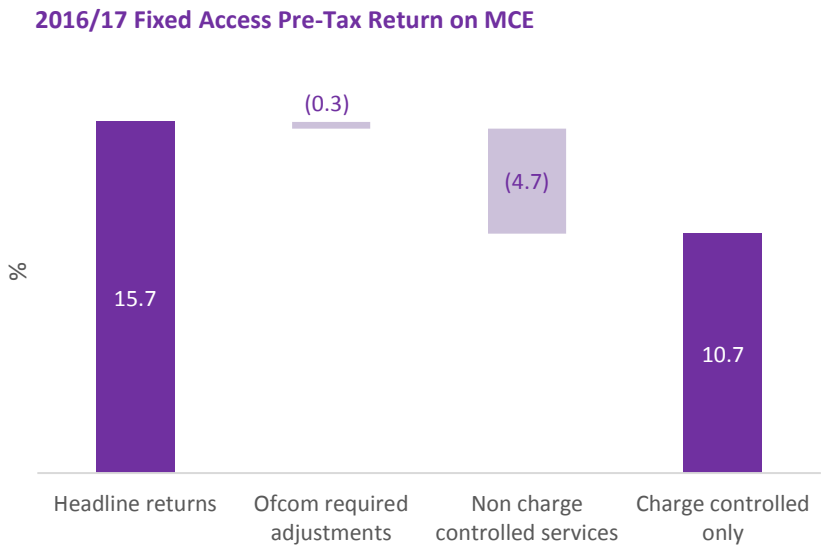
Total revenue in SMP markets is £5,605m for 2016/17.

2016/17 SMP Markets Total Revenue £m



2.2 2016/17 Total Fixed Access Market adjustments:

Total revenue for this market is £4,015m for 2016/17.



The Fixed Access Market headline return of 15.7% is adjusted to 15.4% reflecting the use of asset values consistent with an ongoing network (for example using net replacement costs for line cards) rather than a heavily or fully depreciated measure of assets which is not indicative of forward looking costs.

Considering only charge controlled services, Wholesale Line Rental (WLR) basic and Wholesale Line Access (WLA) copper services, the return on MCE reduces to 10.7%. Note that the returns on charge controlled copper services include holding gains on the indexation of copper assets which were higher in 2016/17 than in recent years due to an increase in the RPI. (See section 3.0 for more details.)

There are no charge controls on the WLR premium service, and there are safeguard caps on ISDN2 and ISDN30 services. ISDN is a legacy service; the equipment is heavily depreciated and hence its costs and returns are not reflective of the long term costs of supply. Ofcom does not require us to reduce prices to depreciated costs as such pricing would disincentivise migration to newer technologies and discourage investment in such technologies.

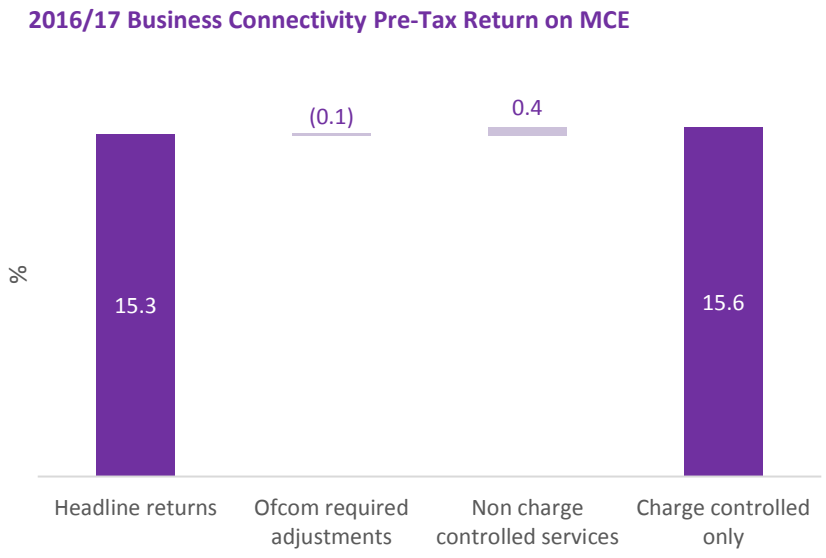
Ofcom is currently consulting on charge controls in the WLA market for the three year period from 1 April 2018. Under Ofcom's proposals further reductions would be required in the prices of WLA copper services while a charge control would be imposed on certain Generic Ethernet Access (GEA) services for the first time, with significant price reductions proposed.

We have been subject to constraints on our GEA pricing, in particular, a requirement for fair and reasonable charges, including to retain a margin between wholesale and retail prices, allowing downstream rivals to compete effectively. Ofcom has also acknowledged indirect constraints on GEA pricing from standard broadband and other infrastructure competitors. Charge controls have not been imposed on GEA services to date, in order to allow us the freedom to set prices to manage our risks in the face of uncertain demand, and to ensure a fair return on investment commensurate with these risks.

GEA is a service in which we have invested at risk, incurred losses as demand emerged, and have still not reached payback. Assessing returns in a single year will not, therefore, give a complete picture of the profitability of these services and, in particular, the different profile of returns over the product life and the risks that we have faced (and continue to face).

2.3 2016/17 Total Business Connectivity Market adjustments:

Total revenue for this market is £1,004m for 2016/17.



The Business Connectivity Market headline return of 15.3% has been adjusted for property and restructuring charges to bring the Return on MCE down to 15.2%. After stripping out non-charge controlled services, the Return on MCE increases slightly to 15.6%.

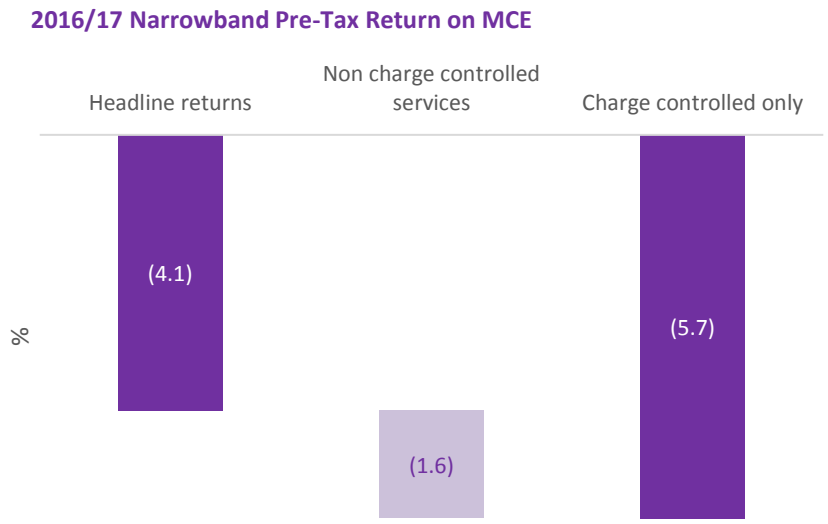
Charge controlled services include CISBO (Contemporary Interface Symmetric Broadband Origination) for both London Periphery and the Rest of UK, where bandwidth is less than or equal to 1 Gbps, as well as Low Bandwidth TISBO (Traditional Interface Symmetric Broadband Origination).

Price reductions of CPI-13.5% have been imposed on the main CISBO basket of services in 2017/18 and of CPI-12.75% in the following year. For the main TISBO basket, price reductions of CPI-3.5% have been imposed in both years.

The impact of BCMR price cuts from 1 April 2017 on this market would have been to reduce Return on MCE by approximately 6.0% (i.e. to circa 9.6% on the adjusted performance basis as reported above) if these prices had been in place in 2016/17. Ofcom has imposed these cuts over the three years of the control using a glide path approach in order to incentivise efficiency (whilst also delivering the benefits of price reductions to customers). By the end of the period, prices will align with Ofcom's forecast.

2.4 2016/17 Total Narrowband Market adjustments:

Total revenue for this market is £204m for 2016/17.



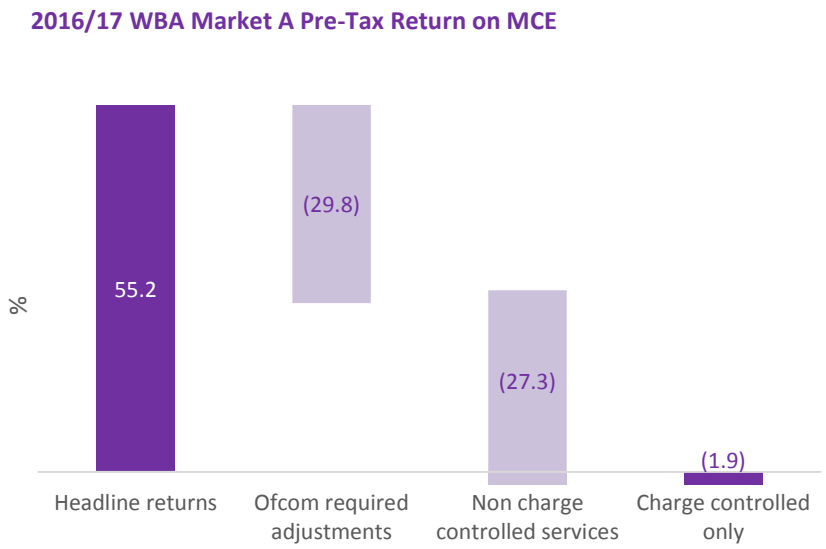
The Narrowband Market charge controlled services are Fixed Call Origination and Fixed Geographic Call Termination, whereas Interconnect Circuits have a safeguard cap.

The Narrowband markets return on MCE is declining, due to a small year on year decrease in Fixed Call Origination and Termination prices, as well as a decline in Fixed Call Origination, Termination and Interconnect volumes that translated to a decline in revenue which was not offset by a decline in costs. Costs have not declined at the same rate due to inflation, asset index increases and constant fixed costs.

The Narrowband charge control were set to target returns to be equal to WACC in the final year of the control. However, Narrowband Return on MCE has fallen below zero (i.e. below the WACC) as a result of additional costs that were allocated to the market without any adjustment to the charge controls following Ofcom's Cost Attribution Review in 2016.

2.5 2016/17 Total WBA Market A adjustments:

Total revenue for this market is £382m for 2016/17.



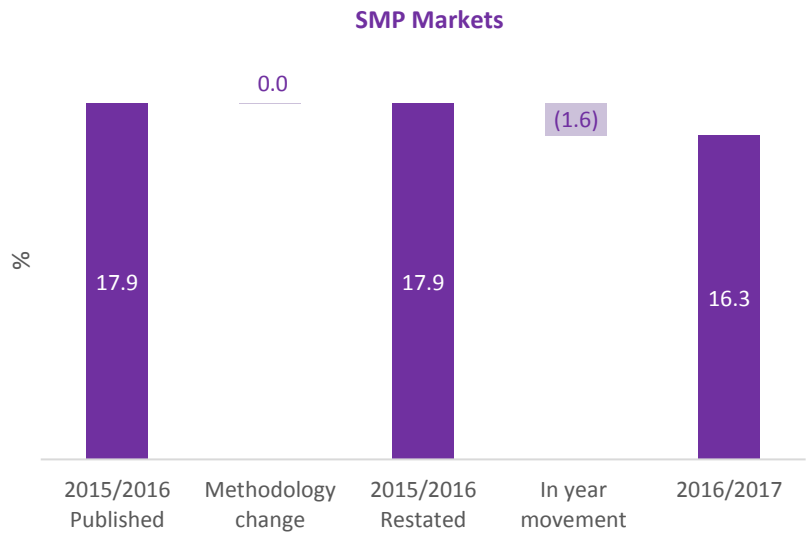
Wholesale Broadband Access (WBA) Market A Return on MCE has a large required adjustment in relation to the HON adjustments of network assets; net replacement cost for ATM (Asynchronous Transfer Mode), ATMW (Asynchronous Transfer Mode Wholesale), SDH (Synchronous Digital Hierarchy) and DSLAMs (Digital Subscriber Line Access Multiplexers). These adjustment are required in order to better reflect the value of these assets in "steady state" rather than the value on the books which reflects the application of standard accounting depreciation and is therefore not indicative of forward looking costs without adjustment.

This reduces the Return on MCE from a headline return of 55.2% to 25.4% (an adjustment of -29.8%). After stripping out the non-price controlled services (which are mainly supplied internally in BT), principally Wholesale Broadband Connect, the Return on MCE decreases further to -1.9%.

Ofcom is currently consulting on the remedies in this market for the three year period from 1 April 2018. Ofcom has provisionally found that the area of the UK in which BT has SMP in WBA (i.e. "Market A") has fallen to exchanges covering circa 2% of the population (compared with 9.5% currently) due to the increased availability of competitor services.

3.0 Year on Year Market Movement Return on MCE:

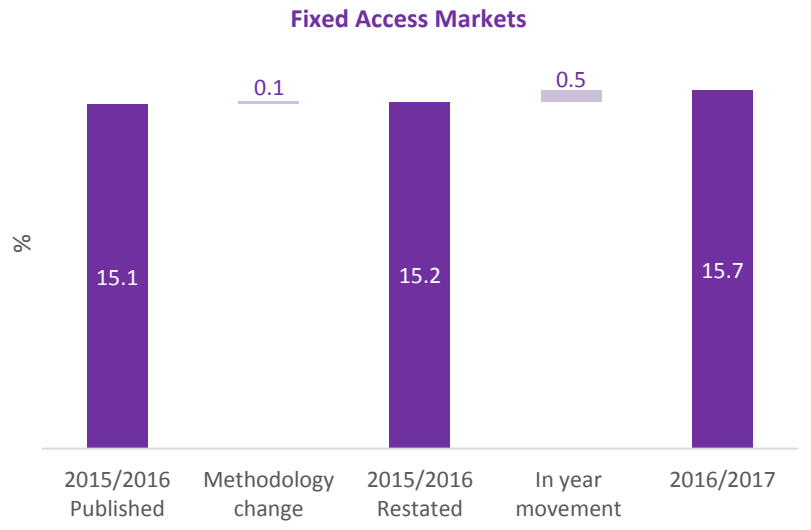
The following charts show the movement in Return on MCE for each of the markets from 2015/16 to 2016/17. This is divided between changes to methodologies in the cost attribution of each market and all other movements in year.



The methodology adjustments for SMP markets in year offset one another which meant that the 2015/16 restated Return on MCE remained unchanged at 17.9%. The in year movement of -1.6% produces a 16.3% Return on MCE in 2016/17.

During the year, there have been significant current cost accounting (CCA) holding gains in copper and duct associated markets from an increase in the RPI index (1.55% in 2015/16 to 3.14% in 2016/17). The increase in the value of the assets is a book adjustment and not realised in our cash flows.

3.1 Year on Year Total Fixed Access Market movements:

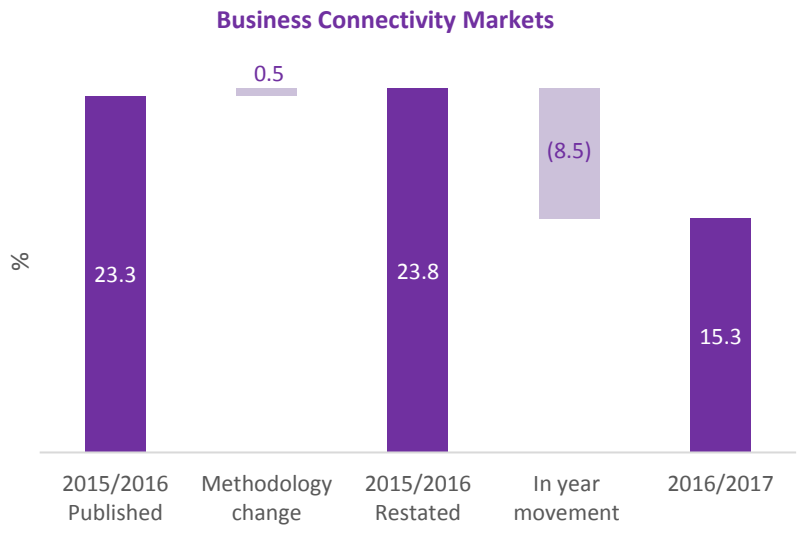


The Fixed Access Market returns have increased from 15.2% (2015/16 restated) to 15.7%, in part due to a change in product mix between copper services, which are subject to charge controls and GEA services, which were not charge controlled in 2016/17, as they are priced to ensure a return that allows us to recover losses incurred in earlier years and to make a return commensurate with the risk of the investment (the “fair bet” principle), albeit constrained by the need to convince price sensitive customers to take higher speed products, and to remain competitive.

Wholesale Fixed Analogue Exchange Line (WFAEL) and copper WLA returns have increased due to a higher CCA holding gain arising from an increase in the copper index.

The Integrated Services Digital Network (ISDN) markets continue to have high returns with a low MCE as a result of the networks’ age and subsequently a high percentage of assets being fully depreciated.

3.2 Year on Year Total Business Connectivity Market movements:

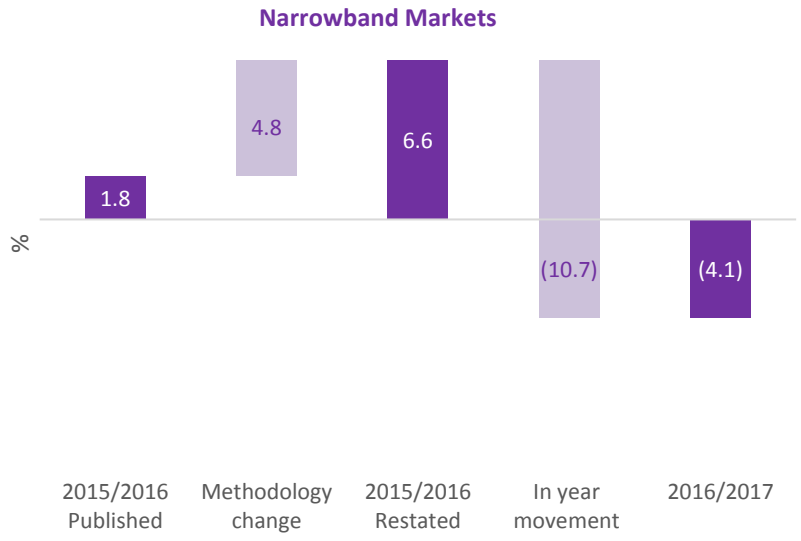


Ethernet and partial private circuit returns have decreased in the year principally due to the impact of the price reductions imposed by Ofcom in the BCMR 2016.

The price reductions were significant, with a starting charge adjustment of 12% on CISBO (Ethernet services) and 7.5% on TISBO services, together with an additional price cut of CPI-13.5% on Ethernet and CPI-3.5% on TISBO services.

Ofcom has also adopted a glide path approach, with further price cuts required for Ethernet services of CPI-13.5% in 2017/18 and CPI-12.75% in 2018/19 and CPI-3.5% price cuts required for TISBO services in both these years.

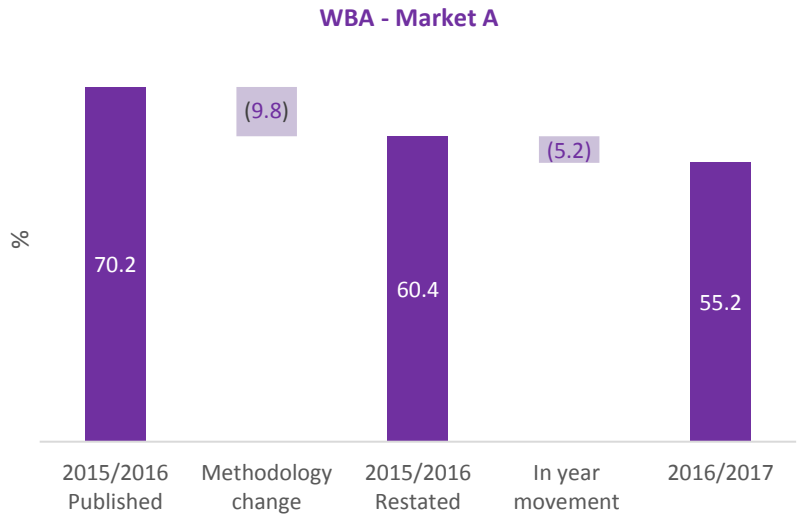
3.3 Year on Year Total Narrowband Market movements:



Volumes in the Origination, Termination and Interconnect markets continue to fall as a result of continued migration from fixed public narrowband networks to mobile networks and the substitution impact of Voice over Internet Protocol ("VoIP") calls, Instant Messaging (IM) and social media.

Prices are not permitted to rise due to the charge controls and safeguard caps in these markets and costs do not fall in proportion to volumes, leading to falling, and negative, returns.

3.4 Year on Year Total WBA - Market A market movements:



Market classifications of certain circuits were changed between Market A and B, which has resulted in a 9.8% decrease in the comparable results with those originally published in 2016.

The decrease in year is primarily due to falling revenue for IPstream, which had a price cap in place of CPI-10.7%.

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