



Regulatory Financial Commentary 2018

BT's commentary
on the Regulatory
Financial Statements
31 July 2018



Disclaimer

This document contains BT's commentary on the 2018 Regulatory Financial Statements (RFS). It reflects our own view and interpretation of the results presented in the RFS and has been produced without any involvement from Ofcom. We have chosen to make this commentary available to assist those with an interest in the accounts to understand them and to understand our interpretation of them. The content of this document and its publication do not form part of our regulatory reporting obligations arising from the SMP conditions imposed on BT.

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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 RFS.

The purpose of charge controls

For certain services, in markets where we are deemed to have SMP, Ofcom has imposed charge controls in the form of annual price reductions of CPI minus X (or RPI minus X). The charge controls fix the maximum prices we can charge over a three year review period. If we meet the cost efficiency targets and volume assumptions set by Ofcom, these prices mean that we would earn Ofcom's expected cost of capital on those services by the end of the period. For 2017/18 this was 8.8% on copper access components and 9.8% for other network components. Our actual returns are measured as a return on Mean Capital Employed (MCE).

Efficiency allows returns above cost of capital

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 greater economies of scale through higher volumes than expected). Equally, we cannot increase prices above the cap if we do not meet the efficiency or volume targets determined at the beginning of the charge control period. Our actual return on MCE on these services may vary from the target set by Ofcom. In the past this method has been an effective incentive in driving efficiency (in telecoms and other regulated sectors) and delivering benefits for consumers.

This document focuses on the return on MCE at the end of each period. It is important to note that return on MCE is a snapshot and may not reflect the returns a service will make on a lifetime basis depending on where we are in a charge control cycle.

Ofcom may set a "glide path" to the final year of the control period so prices move smoothly towards the target over the years of the control, rather than re-basing prices abruptly in the first year of the control. 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. This is balanced against the need to pass the benefit of price reductions to customers in a timely manner. This means the expected returns in the first two years of the control period may exceed that of the third and final year.

Ofcom may choose not to impose a charge control

Ofcom may also reflect service life cycle considerations. For example, legacy products may use older largely depreciated assets, but there are economic reasons not to price in line with low accounting costs as very low prices might delay customer migration to newer products and industry wide investment decisions.

Much of this regulation is specifically designed to serve Ofcom's responsibility to promote competition and encourage investment and innovation in relevant markets, delivering benefits to customers in the form of new services and greater choice. This must be weighed against the short term benefits from price reductions. BT's performance in specific markets must be considered in this broader context.

Ofcom may also choose other forms of control than charge controls (for example a requirement for prices to be "fair and reasonable"). Reasons for choosing a form of control other than a charge control are varied and may include:

- To encourage customers to move to newer technologies;
- Services are expected to become competitive in the near future without a charge control; and
- There is a competing similar product which is already subject to charge control.

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

Differences in reporting from the Annual Report and Accounts

We have prepared the RFS on a Current Cost Accounting (CCA) basis, which differs from the historical cost accounting (HCA) basis used in the Annual Report and Form 20-F. Using CCA, we revalue certain assets each year to their current values, except for access duct, where we must adopt the Regulatory Asset Value directed by Ofcom. Gains or losses on revaluation ("holding (gains)/losses") are taken to the income statement together with differences in annual depreciation charges arising from difference between the CCA and HCA values ("supplementary depreciation").

Where services are provided to, or shared by, Openreach from other parts of BT, we allocate a share of the costs of these activities to Openreach using the methodologies directed by Ofcom. These allocation methodologies differ from those adopted for the Annual Report and Form 20-F.

The RFS also differs in its treatment of Northern Ireland (where activities relating to our access network are included within Openreach results in the RFS, but within our Business and Public Sector unit in the Annual Report and Form 20-F) and may also differ in the treatment of certain specific items. The RFS also excludes specific pension interest and long term interest payable, which only relate to BT Group plc.

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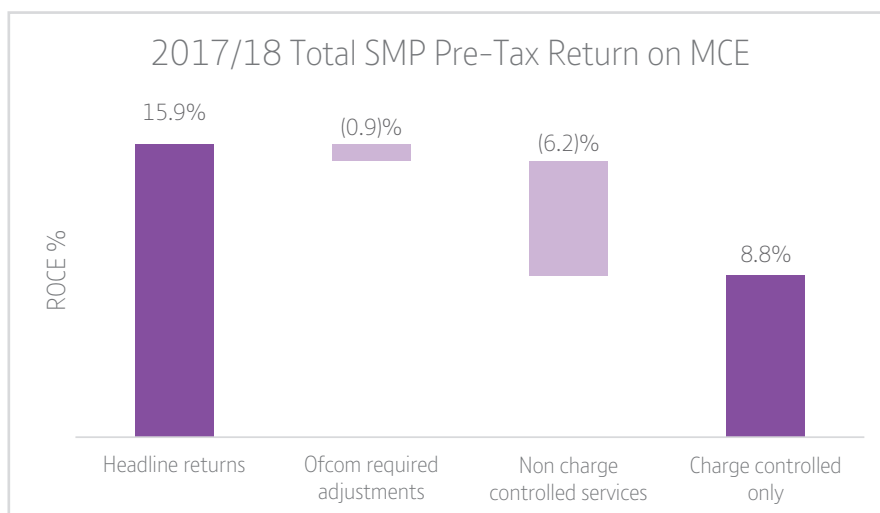
For 2018 the differences are as follows:

Operating Profit 2017/18	Openreach £m	BT Group plc £m
As in the Annual Report and Form 20-F	1,160	3,381
Differences between CCA and HCA	118	73
Differences in costs allocated from other parts of BT (TSO assets and other trading differences)	491	—
Northern Ireland access network activities	88	—
Short term interest payable	—	(30)
Share of post tax loss of associates and joint ventures	—	(1)
As in the RFS	1,857	3,423

2.0 Total SMP market adjustments:

Pre-Tax Return on MCE	2017/18	2016/17 Restated*
Total SMP markets – Performance Summary	15.9%	16.7%
Adjustments as set out in Appendix 2 in the RFS	(0.9)%	(0.9)%
Total SMP markets – Adjusted Financial Performance Basis	15.0%	15.8%
Adjustment to exclude returns from services without charge controls	(6.2)%	(5.3)%
Charge controlled services – Adjusted Performance Basis	8.8%	10.5%

*Restated for methodology changes.



The headline return of 15.9% is adjusted to 15.0% 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. Ofcom requires us to make such adjustments, which are also made for the purposes of modelling charge controls, and publish these in the Adjusted Performance Schedule within the RFS.

As noted in the Introduction above, for many services where we have SMP, forms of price regulation other than a charge control have been imposed for varied reasons. In such instances the regulator does not set or model a target weighted average cost of capital (WACC) that it expects us to achieve. Excluding such services from the reported return on capital gives a return of 8.8%.

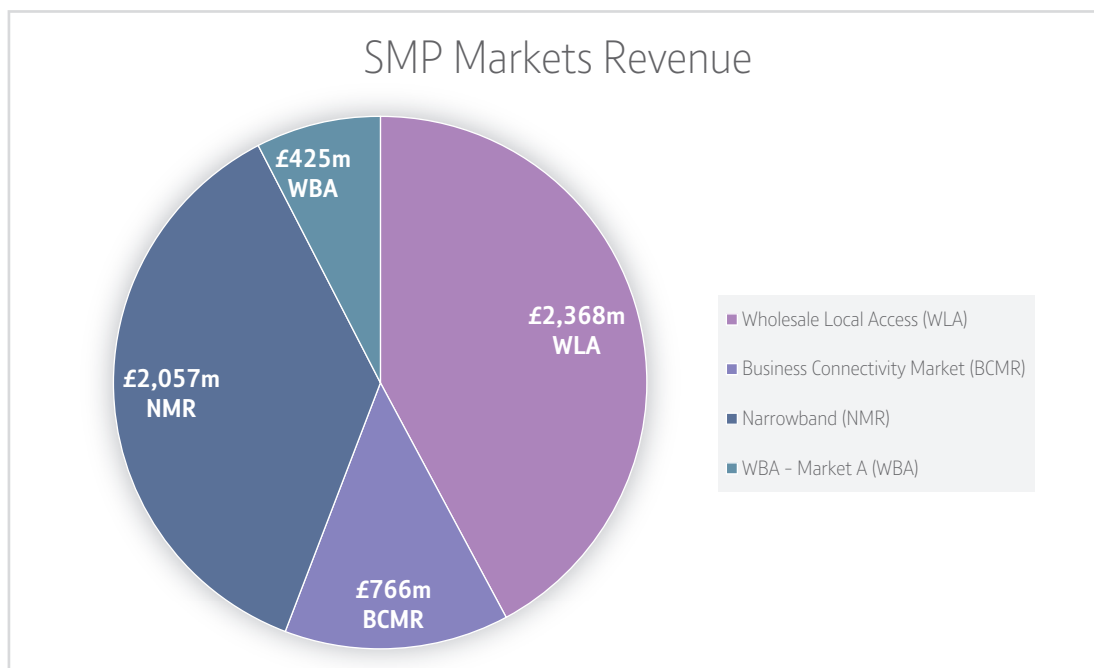
For comparison, the WACC derived by Ofcom in its most recent market review¹ was 8.1% for copper access services and 9.3% for other UK telecoms services.

Note that for the purposes of calculating the return on charge controlled services, we define these as services that were either subject to a CPI-X price cap during both 2016/17 and 2017/18, or which had been subject to such a price cap during 2016/17 and where we made a voluntary commitment to Ofcom to hold constant or decrease prices during 2017/18, pending the outcome of a market review. We do not include in our definition of charge controlled services those that had been subject to either a safeguard price cap only and/or to no price cap in 2016/17; such services were also subject to a voluntary commitment not to raise prices during all or part of 2017/18.

¹ Wholesale Local Access Market Review Statement dated 28 March 2018, paragraph 4.44. WACCs quoted are for 2019/20.

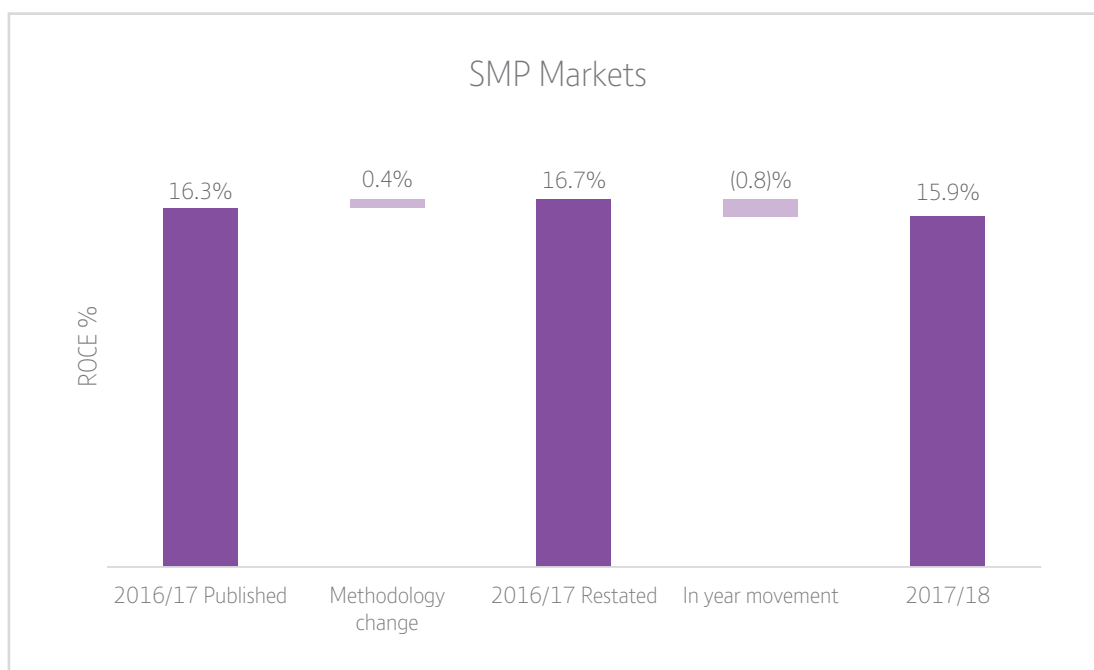
3.0 2017/18 SMP Markets Total Revenue:

Total revenue in SMP markets is £5,616m for 2017/18.



Market Movement Return on MCE:

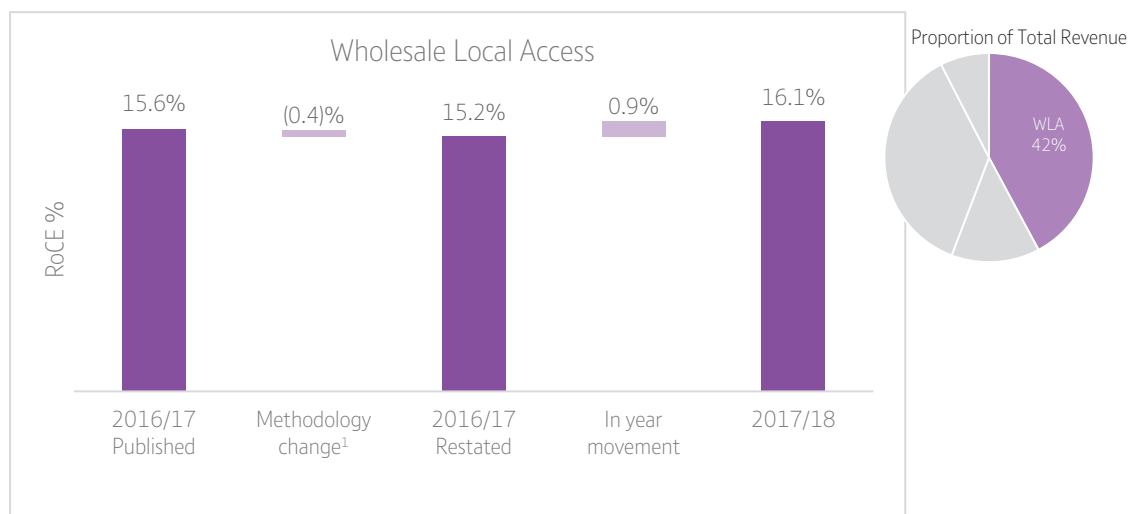
The following chart shows the movement in Return on MCE for each of the markets from 2016/17 to 2017/18.



Returns have fallen year on year due to falling prices and higher service costs in business connectivity markets, combined with flat prices and higher costs of business rates and pensions in most other areas.

Returns in each SMP market are covered on the following pages.

3.1 Wholesale Local Access market review:



¹ Comparative figures have been restated primarily due to a revised methodology for allocation of working capital balances between markets (see RFS Appendix 4 for a full list of changes).

Wholesale Local Access includes MPF (Metallic Path Facility), a copper product which provides communication providers (CPs) with a direct connection to the local network. CPs can install their own equipment in our exchanges, and use it to provide phone and broadband services to their customers. WLA also includes our wholesale fibre product Generic Ethernet Access. We offer a few versions:

Fibre-to-the-cabinet (FTTC) uses fibre from the exchange to the street cabinet, then our copper network for the final link to customers.

G.fast uses fibre from the exchange to the street cabinet, then uses high performance equipment to generate ultrafast speeds over our copper network for the final link to the customers.

Fibre-to-the-premises (FTTP) uses fibre all the way from the exchange to the premises.

The returns on the services covered by the Wholesale Local Access market review have increased from 15.2% (2016/17 restated) to 16.1%, due to a change in product mix between copper services which have been subject to charge controls and fibre services which were not subject to such controls for 2017/18.

Fibre services were subject to a fair and reasonable pricing obligation but were not charge controlled in 2017/18. They were priced to ensure a return that allowed us to recover losses incurred at the beginning of the product life and to make a return commensurate with the risk of the investment (the “fair bet” principle). However, prices were constrained by the need to incentivise customers to take higher speed fibre products. They were also constrained by VULA Margin controls intended to ensure that internally supplied services provided sufficient margin for our downstream businesses to compete effectively and fairly in the market.

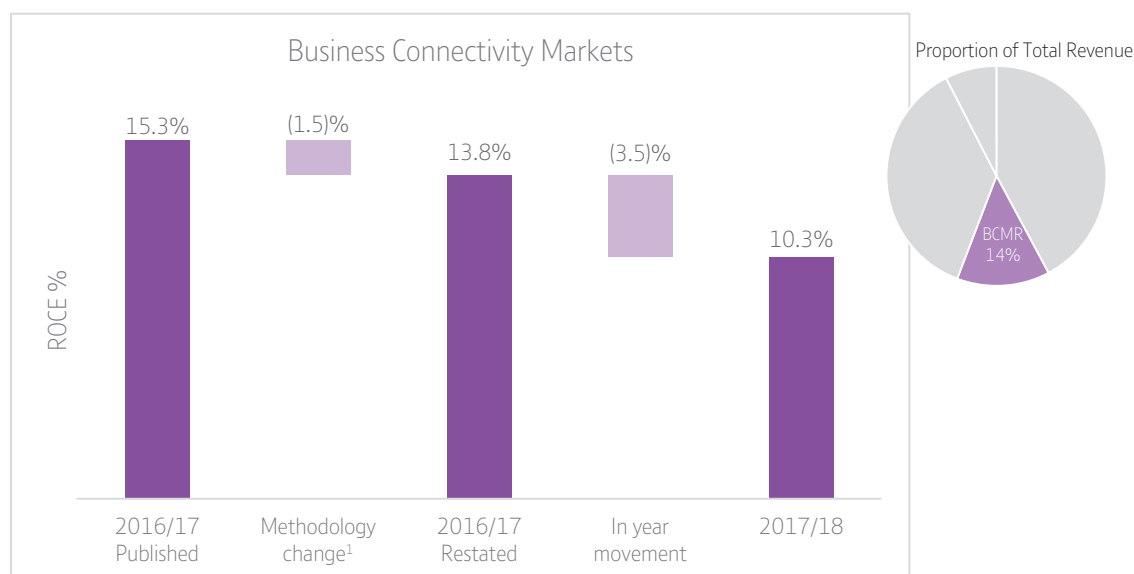
With effect from 1 April 2018, a charge control has been imposed on fibre GEA 40/10 services¹ which will see prices reduce over a three year period. The annual rental for the service will decrease from £88.80 in 2017/18 to £59.91 in 2020/21. This charge control is expected to drive returns in the market significantly lower. Although there are no charge controls on other GEA bandwidth services, there continues to be a fair and reasonable pricing obligation, with the 40/10 price providing a cheaper substitute for the rest of GEA portfolio that keeps prices for higher bandwidth services in check.

A charge control has also been re-imposed on copper access Metallic Path Facility (MPF) with effect from 1 April 2018. This has kept rental prices broadly stable, but requires compliance with more rigorous minimum service levels (MSLs), which will increase operating costs. MSLs have now also been introduced on fibre services.

To give an illustration of the expected impact of these price changes on our future returns, we note that the pre-tax return on MCE of WLA would have been approximately 1.6% lower (i.e. circa 14.5%) if the reduced prices imposed by the charge controls for 2018/19 had been in place in 2017/18 (keeping all other factors unchanged). Note that this illustration does not take into account any price changes that may as a consequence take place on related services, such as GEA services at a bandwidth other than 40/10, not subject to a direct price control.

¹ GEA 40/10: Fibre broadband wholesale service providing up to 40 Mbps downstream and 10 Mbps upstream.

3.2 Business Connectivity Market review (BCMR):



¹ Returns on comparative figures have been restated primarily due to changes in the market definitions together with changes in the fibre valuation and Ethernet electronics allocation methodologies.

This market covers the provision of leased lines – dedicated circuits providing transmission capacity between fixed locations. In this market this includes Ethernet Access Direct (EAD) and Partial Private Circuits (PPC). EAD offers competitive point to point connectivity from 10Mbps to 1Gbps to UK businesses and infrastructure markets. PPCs are traditional leased lines which connect customer sites across our network to a CP's point of handover.

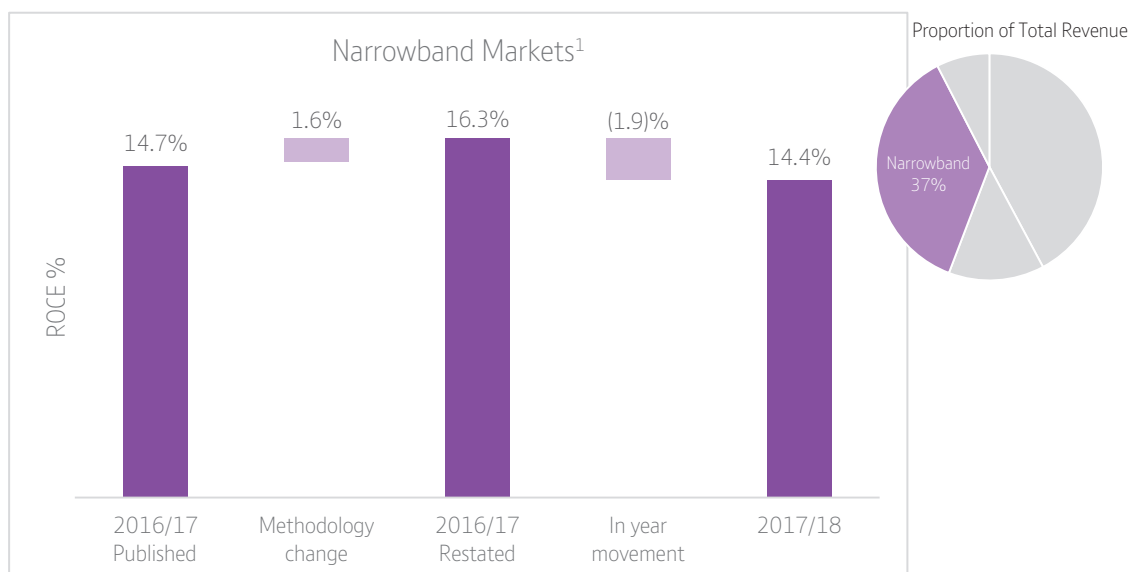
Ethernet and partial private circuit returns have decreased in the year from 13.8% (2016/17 restated) to 10.3%, principally due to the impact of the price reductions required by Ofcom in charge controls it set in the BCMR 2016 and the BCMR 2017 (Temporary Conditions Statement).

The price reductions introduced by the BCMR are significant at CPI-13.5% on Ethernet rental and CPI-3.5% on TISBO services in both 2017/18 and 2018/19.

To give an illustration of the expected impact of these price on our future returns, we note that the pre-tax return on Business Connectivity Markets would have been approximately 2.9% lower (i.e. circa 7.4%) if the reduced prices imposed by the charge controls for 2018/19 had been in place in 2017/18 (keeping all other factors unchanged).

This return would have been below the cost of capital allowed by Ofcom as, in addition to price reductions, there have been significant increases in the cost of business rates charged on network assets and ongoing pension service costs during 2017/18, which were not anticipated when the charge control was set. We expect that these factors may lead to returns in these markets being below their allowed costs of capital in 2018/19.

3.3 Narrowband Market review:



¹ Narrowband markets are markets related to provision of low bandwidth, primarily voice services, including lines. However, prior to the Narrowband Market Review Statement, published on 30 November 2017, lines were shown as part of Fixed Access Markets. The 2016/17 RFS therefore includes only calls markets in "narrowband", not lines markets.

This market covers the provision of products and services that underpin the delivery of fixed line telephone calls. Products include Wholesale Line Rental (WLR), the main product in the Wholesale Fixed Analogue Exchange Line (WFAEL) market. This lets CPs offer phone services to their customers using our equipment and copper network. They pay for lines between our exchanges and their customers' premises. Integrated Services Digital Network (ISDN) is a digital exchange line service that supports telephony and some data services.

The WFAEL and ISDN markets continue to have high returns with low MCE as a result of aging network assets being largely depreciated. Ofcom has not required price reductions in these markets as to do so would discourage migration to newer technologies.

Margins fell during the period as shared costs remained stable despite falling customer volumes and additional business rates and pension charges were incurred.

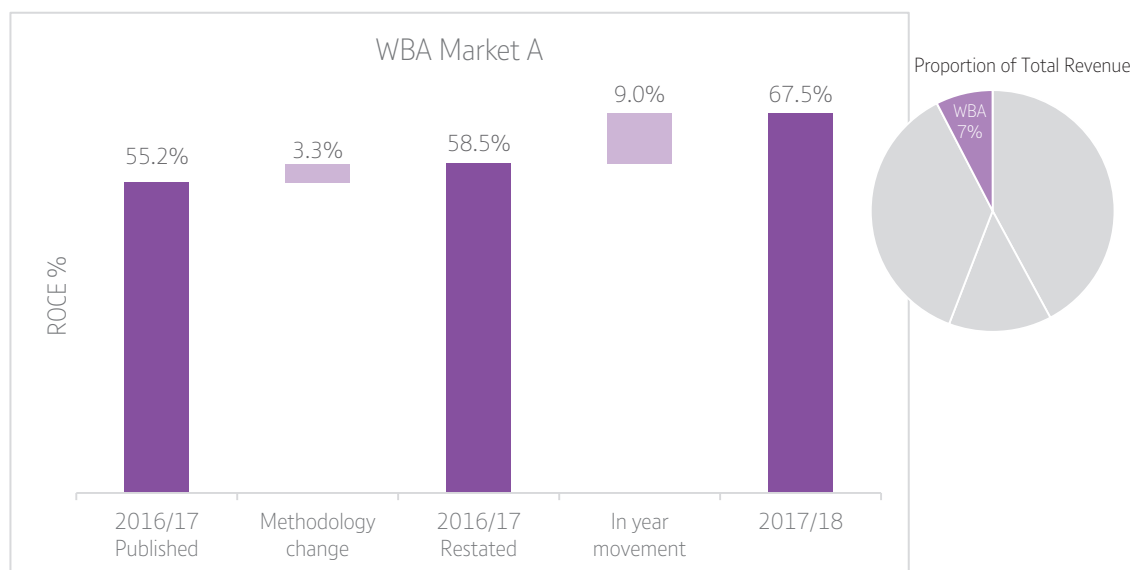
Volumes in the Origination, Termination and Interconnect markets continued to fall as a result of ongoing migration from the fixed Public Switched Telephony Network (PSTN) to mobile networks and the substitution impact of Voice over Internet Protocol (VoIP) calls, Instant Messaging (IM) and social media carried over broadband.

Prices in all markets were kept flat in the first eight months of 2017/18 under a voluntary agreement with Ofcom to cover delays in completing the market review.

A new market review came into effect in December 2017 and will remain in force until March 2021. Except in Call Termination, prices are either subject to caps to prevent price rises (ISDN access and Interconnect) or are not explicitly capped but are required to be "fair and reasonable".

Prices remain constrained by alternatives available in other markets, in particular WLA services such as MPF, which are price capped and act as possible substitutes for narrowband services. Prices also need to comply with the fair and reasonable charges obligation (and to provide sufficient margin for our downstream business). We therefore expect margins to fall further in these markets as customer volumes continue to fall and PSTN and ISDN are prepared for planned closure in 2025.

3.4 WBA – Market A market review:



This market covers the provision of access and backhaul services that allow CPs to provide their end user customers with broadband over fixed lines.

Although returns in this market remain high at 67.5%, Ofcom is not imposing price controls, having recognised:

- The vast majority of revenue in this market (93%) is internal, with external CPs taking alternative services which are readily available from BT or other providers;
- The equipment in this market is heavily depreciated and the book returns do not represent a steady state network; and
- Prices are constrained by competitive pressure. Following market analysis this market has been reduced significantly from July 2018, and now applies to just 0.9% of the UK.



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