



BT

## Regulatory Financial Commentary 2020

### Disclaimer

This document contains BT's commentary on the Regulatory Financial Statements (RFS) for the year ended 31 March 2020. 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 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.

## 1. Introduction

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Under the European and UK regulatory frameworks, regulators regularly review markets to assess whether they are effectively competitive. Where companies are found to have ‘Significant Market Power’ (SMP) the regulator will impose appropriate conditions. This commentary document explains our results in the markets where we<sup>1</sup> have SMP for the year ended 31 March 2020 and should be read in conjunction with the Regulatory Financial Statements (RFS) for that year. In this document we explain how the RFS relates to the Annual Report, discuss the key reporting changes in the year (introduction of the Physical Infrastructure Access (PIA) market), and aim to help the user understand our results.

### 1.1 What is the RFS?

The purpose of regulatory financial reporting is to provide Ofcom with the information necessary to:

- make informed regulatory decisions;
- monitor compliance with SMP conditions;
- ensure that those SMP conditions continue to address the underlying competition issues; and
- investigate potential breaches of SMP conditions and anti-competitive practices.

For these reasons, Ofcom directs BT to produce the RFS, a set of annual product profitability statements. We are required to report our financial performance for all markets (groupings of products and services) where we are deemed to have SMP. Ofcom’s directions<sup>2</sup> include what measures should be published and the allocations and accounting principles used. We take the revenues and costs for BT Group and apportion these to products and services based on the rules as directed by Ofcom. The resulting key differences between the RFS and the BT Group Annual Report are discussed in Section 2 below.

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<sup>1</sup> The terms ‘the Group’, ‘the Company’, ‘BT’, ‘we’, ‘us’ or ‘our’ refer collectively to BT Group plc and its subsidiary undertakings

<sup>2</sup> Most recently the 2019 BT Regulatory Financial Reporting Statement

## 2. RFS Methodology

### 2.1 Differences between the RFS and the BT Group Annual Report

1. The RFS is prepared on a Current Cost Accounting (CCA) basis, which differs from the Historical Cost Accounting (HCA) basis used in the Annual Report. The different basis in the RFS reflects the principle that Ofcom's regulation should incentivise efficient investment in new technologies. The annual report outlines the costs we as a company actually incurred. Using CCA, we revalue certain assets each year to their current values. Gains or losses on revaluation ("holding (gains)/losses") are taken to the income statement together with differences in annual depreciation charges arising from variances between the CCA and HCA values ("supplementary depreciation"). In addition, for access duct, we must adopt a Regulatory Asset Value<sup>3</sup> adjustment as directed by Ofcom.
2. As directed by Ofcom<sup>4</sup>, we make adjustments in the RFS (relative to BT's accounting policies) to treat certain costs as operating expenditure rather than capital expenditure (for more information see [2020 Change Control Notification](#)).
3. Where services are provided to or shared by Openreach from or with 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.
4. BT Group adopted International Financial Reporting Standard (IFRS) 16 from 1 April 2019 on a modified retrospective basis. Lease liabilities were recognised by discounting remaining payments payable under lease arrangements using an appropriate incremental borrowing rate. Right-of-Use (RoU) assets equivalent to the corresponding lease liabilities, adjusted for pre-existing prepaid lease payments, accrued lease expenses and related onerous lease and decommissioning provisions were recognised. However in the RFS, liabilities of more than one year are excluded from the calculation of Capital Employed (CE). To avoid a significant increase in our asset base as a result, reducing the comparability between the ROCE reported in the RFS and Ofcom's approach to setting prices, we have informed Ofcom, and included a portion of the lease liability over one year for property leases in our asset base. This adoption of IFRS 16 in the RFS means there is a minimal impact in our market ROCEs.
5. The group's income statement and segmental analysis separately identifies trading results on an adjusted basis, being before specific items. Specific items are included in returns reported in the RFS.

The adjustments outlined above represent a challenge to stakeholders who wish to compare the RFS to statutory accounts published in our annual report. They add complexity in the preparation of the RFS and reduce its comprehensibility versus accounting standards which are well understood by finance audiences. We continue our dialogue with Ofcom about the intention to improve transparency of the RFS and more closely align it to the accounting standards and financial information that BT uses to manage the business. A closer aligned RFS and annual report would minimise any reconciliation needed between the two publications and aid stakeholders understanding of the business.

For 2020 the differences were as follows:

<b>Adjusted operating profit to RFS return reconciliation 2019/20</b>	<b>Openreach</b>	<b>BT Group plc</b>
	<b>£m</b>	<b>£m</b>
Adjusted operating profit as per Annual Report	1,146	3,611
Specific Items	(49)	(328)
Differences between CCA and HCA	42	38
Differences in costs allocated from other parts of BT <sup>5</sup>	321	-
Difference as a result of expensing capitalised installation costs	(116)	(116)
Short term interest	-	(4)
Share of post tax profit of associates and joint ventures	-	(33)
Other	(4)	-
<b>Return as in the RFS</b>	<b>1,340</b>	<b>3,168</b>

<sup>3</sup> Most recently directed in condition 11.10 of Annex 26 to the 2019 PIMR and BCMR statement, for more information see 2020 AMD section 2.1.3.

<sup>4</sup> WLA Market Review statement (28 March 2018) and most recently in the BT Regulatory Financial Reporting statement (12 July 2019).

<sup>5</sup> Technology assets and other trading differences.

## 2.2 Key change in the year - PIA

The Physical Infrastructure Access (PIA) market is comprised of duct and poles i.e. the infrastructure used to carry cables used by all connectivity services within different downstream markets (such as WLA and Wholesale Fixed Analogue Exchange Line (WFAEL)) to facilitate the provision of network access and services to the end customer. Duct exclusively used for cabinet connectivity for the Fibre to the Cabinet (FTTC) network is excluded from the PIA market, as it is not usable by third parties.

In 2019/20 we have separated PIA into its own market, with the duct and pole assets previously reflected in the downstream markets now reported in the PIA market. Margins for Openreach as a whole are unaffected as this reporting change has not created new assets. However, it does result in a change of the downstream markets' ROCE, as assets are no longer reflected in these markets and are instead charged a notional cost from the PIA market.

## 3. Summary Results

		2019/20 Published	2019/20 (Pre -PIA basis)	2018/19 Restated	2018/19 Published	Ofcom WACC
Market (Proportion of total SMP returns 2019/20)	Key Products	ROCE %	ROCE %	ROCE %	ROCE %	%
Physical Infrastructure Access Market (27.5%)	Duct Poles	7.1	-	7.1	-	7.1
Wholesale Local Access Market (26.8%)	MPF <sup>(a)</sup> FTTC FTTP <sup>(a)</sup>	7.1	7.1	12.6	10.7	8.9 <sup>6</sup>
Business Connectivity Markets (10.3%)	EAD <sup>(a)</sup>	10.0	9.1	7.4	n/a <sup>7</sup>	8.0
Openreach Narrowband Markets (31.8%)	WLR <sup>(a)</sup>	15.5	11.8	16.6	12.0	7.1
Rest of BT SMP Markets (3.6%)	Calls <sup>(a)</sup> WBC <sup>(a)</sup>	15.4	14.0	6.9	6.9	11.0
<b>Total SMP</b>		<b>9.1</b>	<b>9.2</b>	<b>10.8</b>	<b>10.0</b>	<b>8.3<sup>8</sup></b>

Notes:

a) Metallic Path Facilities (MPF); Fibre to the Premises (FTTP); Ethernet Access Direct (EAD); Wholesale Line Rental (WLR); Wholesale Broadband Connect (WBC); Call Origination and Call Termination (Calls).

### 3.1 Comparison of Ofcom's WACC to Reported Return

This commentary explains variations in BT's returns with reference to Ofcom's estimated (i.e. forward looking at the time of the relevant market review) Weighted Average Cost of Capital (WACC). BT's actual returns are measured as a return on mean capital employed (MCE).

Returns were in line with Ofcom's cost of capital for the PIA market.

In the WLA market, the reduction in ROCE (from 2018/19 Restated to 2019/20 Published) was mainly due to investment in the fibre network, and commercially driven volume discount offers announced by Openreach in 2018. WLA ROCE was lower than Ofcom's estimated WACC reflecting our upfront investment in the fibre network.

Increased returns in Business Connectivity markets reflect higher revenues driven by demand in higher bandwidth products, whilst costs and investment remained stable. Whilst ROCE is higher than Ofcom's forecast, WACC is within the range<sup>9</sup> of the returns Ofcom expected as part of the 2019 Business Connectivity Market Review in which it moved its control to flat nominal pricing.

<sup>6</sup> Ofcom WACC is 8.1% for WLA Copper services and 9.3% for WLA Fibre services. Blended WACC of 8.9% is weighted based on MCE.

<sup>7</sup> The Business Connectivity Markets have been restructured following the Promoting competition and investment in fibre networks: review of the physical infrastructure and business connectivity markets – PIMR, BCMR, and Leased Lines Charge Control (LLCC). Final statements were published 28 June 2019 and therefore comparison to 2018/9 published ROCE is not appropriate.

<sup>8</sup> Annex A21 of the 2019 PIMR and BCMR statement (28 June 2019)

<sup>9</sup> Ofcom as detailed in A 18.5 to the 2019 PIMR and BCMR statement considered a CPI-CPI charge control could lead to an recovery of costs up to £80m (14.0% ROCE) and an under recovery of up to £40m (5%ROCE) over the review period to March 2021.



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Returns fell in the Narrowband markets as customers continue to move to fibre-based products and mobile technology replaces copper fixed lines. Returns are higher than WACC reflecting the largely fully depreciated assets in this market.

Higher returns in Rest of BT SMP markets were driven by increased bandwidth revenues and cost and MCE reductions due to the withdrawal of the 20<sup>th</sup> Century Network (20CN) network. Returns are in excess of the most comparable WACC for these markets driven by high returns resulting from heavily depreciated equipment, and higher bandwidth demand which doesn't attract significant costs.

The ROCE for each regulated type of SMP market are discussed further on pages 7 to 10.

### 3.2 2018/19 Published to 2018/19 Restated

Annually we must restate our prior year reported results to incorporate methodology changes during the year as directed by Ofcom. This resulted in an increase in ROCE from 10.0% (2018/19 published) to 10.8% (2018/19 restated; see [2020 Change Control Notification](#) (CCN)<sup>10</sup> for more information).

### 3.3 Comparison of 2018/19 Restated to 2019/20 Published

SMP Market Total	2019/20 Published	2018/19 Restated	2018/19 Published
Revenue <sup>11</sup>	£5.8bn	£5.7bn	£5.1bn
Operating Costs	£4.5bn	£4.3bn	£3.7bn
MCE	£14.0bn	£13.2bn	£13.6bn
ROCE	9.1%	10.8%	10.0%

The fall of 1.7 percentage points, between the 2018/19 restated and 2019/20 published ROCE, was driven by lower returns and higher MCE:

- MCE was £14.0bn, up 5.9% from 2018/19 restated, driven by investments in the network (predominantly fibre enabled infrastructure).
- Revenue was up 1% from 2018/19 restated. This was driven by higher rental bases in fibre enabled products supported by commercial offers introduced to encourage customer to migrate to superfast broadband, and Ethernet. The revenue effect of volume increases was partially offset by price reductions (both the impact of Openreach's commercial offer of fibre volume discounts, and regulated price reductions), and higher service level guarantee payments due to implementation of auto-compensation.
- The revenue growth was more than offset by operating costs, up 5% from 2018/19 restated, primarily driven by higher business rates and higher salary costs as Openreach invested in more colleagues to support the FTTP rollout and better service, and pay inflation. These drivers were partly offset by efficiency savings.

### 3.4 Impact of PIA

In the market summary table above we have presented the 2019/20 ROCE on a pre-PIA basis, as if assets were recognised following the old market structure (reported in the 2018/19 published RFS).

Total SMP ROCE has moved slightly from 9.2% on a Pre-PIA basis to 9.1% on a published basis. On a Pre-PIA basis duct and poles are allocated to non SMP markets with no impact on SMP ROCE. On a published basis duct and poles are transferred to the PIA market (included in SMP) where returns are 7.1%, reducing SMP returns.

<sup>10</sup> 2020 Change Control Notification

<sup>11</sup> 95.5% of SMP revenue is Openreach, with remainder 4.5% being Rest of BT

## 4. Review by Market Return

### 4.1 Physical Infrastructure Access Market

#### Products

The PIA market is comprised of duct and poles i.e. the infrastructure used to carry cables used by all connectivity services within different downstream markets (such as WLA and WFAEL) to facilitate the provision of network access and services to the end customer.

#### Return

	2019/20 (Published)			2018/19 (Restated)			2018/19 (Published)		
	Return £m	MCE £m	ROCE %	Return £m	MCE £m	ROCE %	Return £m	MCE £m	ROCE %
PIA	351	4,939	7.1	340	4,782	7.1	N/a	N/a	N/a

Currently less than 1% of PIA revenue is external although volumes continue to grow. Internal revenue is a recharged to downstream markets at cost plus an allowable return (7.1% of MCE). As such, given very low external revenues, this results in a ROCE of 7.1% (consistent with Openreach cost of capital of 7.1%). The MCE has increased to £4,939m (2018/19 restated: £4,782m) as a result of continued investment in local duct for optical fibre.

### 4.2 Wholesale Local Access Markets

#### Products

WLA refers to copper and fibre lines used by Communication Providers (CPs) to connect residential and business end-users to their voice or broadband nodes located in BT exchanges.

Our wholesale copper product consists of two variants:

- MPF provides CPs with a copper connection between the exchange and the premises; and
- Shared MPF (SMPF) is used by CPs to provide broadband over a copper line alongside a voice service on the same line which may or may not be provided by the same CP.

Our wholesale fibre product GEA consists of two main variants:

- FTTC uses fibre from the exchange to the street cabinet, then our copper network for the final link to the premises; and
- FTTP uses fibre all the way from the exchange to the premises.

Ofcom's WLA market review, which took effect on 1 April 2018, maintained a charge control on copper products and calculated a cost of capital for these copper services of 8.1%. The same review also imposed a charge control for the first time on the lower speed Openreach fibre GEA 40/10 services (referred to as the 'anchor product' by Ofcom) whereby prices would reduce to cost (plus WACC) over the period 1 April 2018 to 31 March 2021. Products at speeds above the anchor have not been charge controlled; this is because the availability of GEA 40/10 at cost provides a degree of pricing constraint also on higher bandwidth products, while at the same time incentivising our and other operators' investment in FTTP.

#### Return

	2019/20 (Published)			2018/19 (Restated)			2018/19 (Published)		
	Return £m	MCE £m	ROCE %	Return £m	MCE £m	ROCE %	Return £m	MCE £m	ROCE %
WLA	342	4,814	7.1	520	4,142	12.6	650	6,077	10.7

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Restated ROCE increased to 12.6% (from 2018/19 published to restated). A key driver was the introduction of the PIA market which reduced the capital employed in the WLA market by transferring depreciation and assets from WLA to be reported in the PIA market. These were replaced with a recharge reflecting use of these assets as discussed above.

During the year, ROCE has reduced to 7.1%. This is in line with expectations given the high levels of upfront investment in building out the fibre network and increased business rates. In addition, we have seen a full year impact of the commercially driven volume discount offers announced by Openreach in 2018, which covered Openreach FTTP and FTTC wholesale services, and gave CPs access to discounts in return for upgrading their customers from predominantly copper-based services to GEA- FTTC, G.fast and GEA-FTTP.

The adjusted average return in this market published in the RFS is below the estimate Ofcom used for forward looking WACC in its regulation for the charge control period up to 2021 (8.1% for Copper and 9.3% for GEA Fibre products). This is because the WLA market as reported in the RFS includes our investments in FTTP, which are still in their early stages (as is customer migration).<sup>12</sup> Absent these adjustments, MCE would show returns in this market slightly above WACC.

### 4.3 Business Connectivity Markets

#### Products

The Business Connectivity markets contain Ethernet technology-based products. The regulated markets are split by geography, product type (access services or inter-exchange connectivity services) and competitiveness. The Contemporary Interface (CI) Access Markets provide connections to end-user business sites and the Inter-exchange Markets provide the core and backhaul connections between BT exchanges in different geographic areas. The services predominantly include:

- EAD offers competitive point to point connectivity to UK businesses and infrastructure markets;
- Optical Spectrum Access (OSA) provides a highly secure, flexible and cost-effective way of moving very large amounts of data between UK-wide locations via dedicated fibre links. They operate using Dense Wavelength Division Multiplexing (DWDM) technology; and
- Ethernet Backhaul Direct (EBD) which is a highly efficient and cost-effective way of delivering large volumes of data, quickly and securely.

#### Return

	2019/20 (Published)			2018/19 (Restated)			2018/19 (Published)		
	Return £m	MCE £m	ROCE %	Return £m	MCE £m	ROCE %	Return £m	MCE £m	ROCE %
Business Connectivity Markets	132	1,323	10.0	97	1,309	7.4	N/a	N/a	N/a

The 2019 Business Connectivity Market Review and Leased Lines Charge Control significantly redefined the Business Connectivity markets which therefore means comparison to 2018/9 published ROCE would be inconsistent.

ROCE for the Business Connectivity markets increased to 10.0% (2018/19 restated: 7.4%). Revenues were up and costs were largely consistent with 2018/19 restated. The revenue increases reflect higher demand in high bandwidth and newer technology products.

<sup>12</sup> We expect the return on our FTTP investment to exceed our cost of capital over the lifetime of the investment as we expect Ofcom to allow us to earn an amount above our WACC over the lifetime of the FTTP investment reflecting the project specific risk of the investment, in line with the "Fair Bet". Because regulation would disincentivise investment if the expectation of price caps (set at WACC) curtailed the upside in a risky investment, Ofcom allowed returns above WACC for our FTTC investment in the later years of the investment and setting a charge control only in 2018 for speeds at 40/10 Mbps and below, which was expected to glide to cost plus WACC by 2021. Thus 'Fair Bet' regulation in the later years of the investment in FTTC reflected losses in the earlier years when we had invested in the FTTC network ahead of customers migrating to it (and reflecting uncertain demand and cost at the time).



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The Leased Lines Charge Control was published as part of the Business Connectivity Market Review 2019, and set prices at a safeguard cap of flat nominal pricing. Ofcom estimated that there may be some over or under recovery as a result of this. Our returns of 10.0% although slightly above Ofcom's estimated WACC of 8.0%, is within this range.

## 4.4 Openreach Narrowband Markets

### Products

Openreach narrowband market includes WFAEL and ISDN services. WLR, the main product in the WFAEL market 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. ISDN is a digital exchange line service that supports telephony and some low bandwidth data services.

### Return

	2019/20 (Published)			2018/19 (Restated)			2018/19 (Published)		
	Return £m	MCE £m	ROCE %	Return £m	MCE £m	ROCE %	Return £m	MCE £m	ROCE %
Openreach Narrowband Markets	406	2,618	15.5	446	2,684	16.6	581	4,838	12.0

Restated ROCE for the Narrowband markets increased to 16.6% (2018/19 published: 12.0%). A key driver was the introduction of the PIA market which reduced the capital employed by transferring depreciation and assets from Narrowband to the PIA market. These were replaced with a recharge reflecting use of these assets as discussed above.

ROCE for the Narrowband markets reduced to 15.5% (2018/19 restated: 16.6%). This is expected, as the WFAEL, ISDN2 and ISDN30 markets all continued to see a decline in volumes and revenues which outweighed the impact of reduced costs as customers continue to move to fibre-based products, and mobile technology replaces copper fixed lines.

Returns are higher than the Openreach cost of capital of 7.1% used in Ofcom's charge control models, as many assets are heavily depreciated. Reported returns are not representative due to the low asset values (MCE), and once we have adjusted for the hypothetical ongoing network (HON)<sup>13</sup> returns are closer to Ofcom's estimated WACC. Many of these products are older and Ofcom expects customers to migrate to newer products and services.

## 4.5 Rest of BT SMP Markets

### Products

This market includes Calls services, Wholesale Broadband Access (WBA) Market A and all other non-Openreach products and services.

WBA Market A covers the provision of access and backhaul services that allow CPs to provide end-user customers with broadband over fixed lines. WBA offers copper and fibre products and utilises 20<sup>th</sup> Century Network (20CN) and 21<sup>st</sup> Century Network (21CN) platforms. The 20CN network offers legacy broadband services (IPstream). The 21CN services are Wholesale Broadband Connect (WBC), Wholesale Broadband Managed Connect (WBMC),

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<sup>13</sup> The HON adjustment is made by Ofcom in its charge control modelling of legacy services to ensure that the prices set reflect the economic costs required for entrants to supply an equivalent service. This adjustment affects services which utilise assets that are nearly fully depreciated including Integrated Services Digital Network (ISDN)2 and ISDN30 rental services, Partial Private Circuits and Radio Backhaul Services (found in the Traditional Interface Symmetric Broadband Origination (TISBO) market), WLR services and WLA ancillary and MPF (Metallic Path Facility) services.

The HON adjustment made is different to the adjustment made in the Adjusted Financial Performance Summary (Section 5.5) to the RFS. The adjustment made within this Commentary includes all adjustments made by Ofcom in the 2018 WLA Charge Control Modelling, whilst the RFS adjustment only includes those which Ofcom directs us to report.

For more details of the adjustments made here see the 2019 Regulatory Financial Commentary.

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Broadband Boost, Super Fast Broadband (SFBB), Harmonised Ethernet and Managed Ethernet Access Service (MEAS) and other smaller products.

### Return

	2019/20 (Published)			2018/19 (Restated)			2018/19 (Published)		
	Return £m	MCE £m	ROCE %	Return £m	MCE £m	ROCE %	Return £m	MCE £m	ROCE %
Rest of BT SMP Markets	46	299	15.4	21	292	6.9	44	644	6.9

Restated ROCE for rest of BT SMP Markets is consistent with prior year published ROCE. Returns are impacted by the fall in asset base following the introduction of the PIA market.

ROCE for Rest of BT SMP Markets increased to 15.4% (2018/19 restated: 6.9%), driven by increased bandwidth revenues and cost and MCE reductions due to the withdrawal of the 20CN network. The equipment in this market is heavily depreciated and the book returns do not represent a steady state. The intention is to move customers to newer networks so as to be able to close the networks down. Calls market ROCE continues to be negative and fell 3.1 percentage points on declining volumes as customers migrated to newer technologies.

Returns are in excess of the most comparable WACC for these markets (11%) driven by high returns in WBA Market A, resulting from heavily depreciated equipment, and higher bandwidth demand which doesn't attract significant costs.



**BT Beyond Limits Brand Launch, London, Wembley Arena.**  
October 2019. BT launched its new brand ambition – Beyond Limits – with an epic World Record-breaking indoor drone show coded by school children from St Joseph’s School, Islington.

**BT Group plc**

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