Key messages

Average SMP Return on capital employed (ROCE) across all markets is down year on year by 1.5% from 8.9% 2019/20 (restated) to 7.4% in 2020/21, driven by:

Higher costs, as a result of:

- A lower Current Cost Accounting (CCA) revaluation adjustment as a result of lower RPI increases this year, (as this adjustment offsets costs, costs are therefore higher compared with 2020);
- Increased engineer pay driven by recruitment and training to support fibre rollout, pay inflation and a special frontline bonus; and

Higher mean capital employed (MCE) as a result of:

- Upfront investment in the fibre network ahead of demand (also resulting in higher depreciation); and
- Higher cash and cash equivalents.

Returns in each market are broadly aligned to the Ofcom WACC when we consider the following:

<u>Ofcom adjustments in cost modelling, not in the RFS</u>

For this RFS period, when Ofcom estimated the efficient cost reflective prices for copper legacy services (LLU and WLR) and FTTC, Ofcom made adjustments in its cost modelling that are not reflected in the RFS. These adjustments included:

- Transferring cost from copper services to FTTC services ("common cost transfer"[1]);
- Adjusting some legacy assets' values to reflect the costs of a Hypothetical Ongoing Network (HON adjustment[2]);

When we re-present the returns for these services after making the same adjustments, the returns for copper and FTTC services are within 1% of Ofcom WACC (see section 4.2 for more details).

<u>RFS reflects in-year accounting returns</u>

ROCEs reported in the RFS reflect in-year profitability. FTTP returns are negative, as would be expected at the early stage of the product life cycle when the network is being built in advance of demand. This depresses the reported returns for the WLA market. The dis-aggregated returns for legacy (LLU and FTTC) is 15% and for FTTP is (17)% (see section 4.2 for more details).

[1] Ofcom's adjustment in its 2018 WLA charge control modelling is not currently reflected in the methodologies we apply in the RFS. In the 2018 WLA charge control Ofcom calculated the common costs shared between copper and fibre services, and reallocated those costs based on a proportional basis of long run incremental costs of WLA and Openreach Narrowband services, resulting in a shift of common cost from copper services – both within the WLA and in the Narrowband Market – to FTTC .

[2] The HON adjustment is made by Ofcom in its charge control modelling and involves "uplifting the value of BT's heavily depreciated assets (mainly exchange equipment) to reflect the cost of maintaining a network on an ongoing basis" (Ofcom 2019, Promoting competition and investment in fibre networks, paragraph 2.14). 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.

1. Introduction

Under the UK regulatory frameworks, Ofcom reviews markets regularly to assess whether they are effectively competitive. Where companies are found to have 'Significant Market Power' (SMP) Ofcom will impose appropriate conditions. This commentary document explains our results in the markets where we[3] have SMP for the year ended 31 March 2021 and should be read in conjunction with the Regulatory Financial Statements (RFS) for that year. We also explain how the RFS results relate to the presentation in the BT Group Annual Report.

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 this reason, 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[4] include what measures should be published and the allocations and accounting principles to be 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.

[3] The terms 'the Group', 'the Company', 'BT', 'we', 'us' or 'our' refer collectively to BT Group plc and its subsidiary undertakings
[4] Most recently the BT Regulatory Financial Reporting Statement published 12 July 2019

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.** This 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 apply a Regulatory Asset Value[5] adjustment as directed by Ofcom.
2. **Ofcom directs that certain costs are treated as operating expenditure rather than capital expenditure in the RFS (relative to BT's accounting policies)** [6]**.**
3. **We allocate a share of costs where services are provided to, or shared by, Openreach from or with other parts of BT.** We use the methodologies directed by Ofcom and these differ from those adopted for the Annual Report.
4. **The impact of BT Group's adoption of International Financial Reporting Standard (IFRS) 16 from 1 April 2019, on a modified retrospective basis, is different in the RFS to the Annual Report**. 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 we have included, a portion of the lease liability over one year for property leases. This adoption of IFRS 16 in the RFS means there is a reduced impact in our market ROCEs.
5. **The income statement and segmental analysis in the Annual Report separately identifies trading results before specific items**. Specific items are included in returns reported in the RFS.

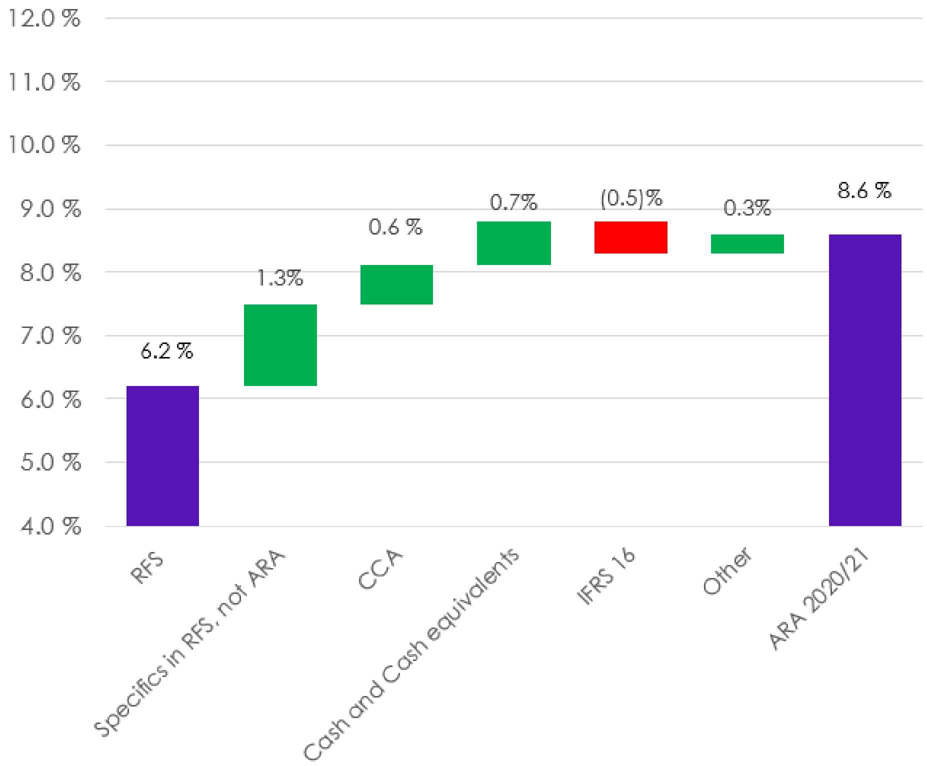
The adjustments outlined above represent a challenge to stakeholders who wish to compare the RFS to statutory accounts published in our Annual Report. We continue our dialogue with Ofcom about the intention to improve transparency of the RFS and more closely align it to the accounting standards.

Adjusted operating profit to RFS return reconciliation 2020/21	Openreach £m	BT Group plc £m
Adjusted operating profit as per Annual Report	1,230	3,068
Specific Items	(102)	(481)
Differences between CCA and HCA	(79)	(80)
Differences in costs allocated from other parts of BT	212	-
Difference as a result of expensing capitalised installation costs	(108)	(108)
Short term interest	(2)	(12)
Share of post tax profit of associates and joint ventures	-	8
Rounding	-	-
Return as in the RFS	**1,151**	**2,395**

[5] Most recently directed in condition 11.10 of Annex 26 to the 2019 PIMR and BCMR statement.
[6] WLA Market Review statement (28 March 2018) and most recently in the BT Regulatory Financial Reporting statement (12 July 2019).

2.2 RFS and the BT Group Annual Report ROCE

For 2020/21 the ROCE differences were as follows:



Ofcom directs the following are included in RFS ROCE:

- Cash and equivalents;
- Specific revenue and costs (such as restructuring costs);
- Current cost adjustments (revaluation of assets recognised against operating cost); and
- IFRS16 adjustment for the non current portion of the Telereal property lease liability.

Group ROCE of 8.6% is shown on page 198 of the 2021 BT Group Annual Report.

3. Summary Results

3.1 Comparison of Ofcom's WACC to Reported Return

This commentary explains variations in BT's returns with reference to Ofcom's forward looking estimates of Weighted Average Cost of Capital (WACC), made at the time of the relevant market review. BT's actual returns are measured as a return on MCE[7].

3.2 2019/20 Published to 2019/20 Restated

Annually we are directed by Ofcom to restate our prior year reported results to incorporate changes as described in the Reconciliation Report (Appendix 4 to the RFS). This resulted in a decrease in ROCE from 9.1% (2019/20 published) to 8.9% (2019/20 restated; see 2021 RFS for more information).

3.3 Comparison of 2019/20 Restated to 2020/21 Published

Published vs restated results for all SMP markets

	2020/21	2019/20 Restated	2019/20 Published
	£m	£m	£m
Revenue[8]	6,027	5,754	5,760
Operating Costs	4,801	4,538	4,525
CCA cost impact	80	(40)	(42)
Total CCA Operating Costs	4,881	4,498	4,483
Return	1,146	1,256	1,277
MCE	15,539	14,018	13,993
ROCE	7.4%	8.9%	9.1%

The fall of 1.5 percentage points, between the 2019/20 restated and 2020/21 published ROCE, was driven by lower returns and higher MCE:

- SMP revenue was £6,027m, up 5% primarily due to higher rental bases in fibre products (FTTC, FTTP and Ethernet), partially offset by declines in legacy copper products.
- Total CCA operating costs were £4,881m, up 9% driven by a lower RPI[9] annual increase generating a reduced CCA holding gain (and so increasing operating costs, compared with 2020), and driven by recruitment and training to support fibre rollout, pay inflation and a special frontline bonus.
- MCE was £15,539m, up 11%, due to investment in the fibre network (FTTP build) and connecting our customers, and higher cash and cash equivalents. This was partly offset by the declining copper asset base.

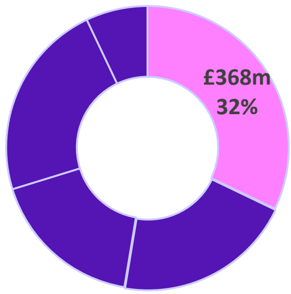
[7] Mean Capital Employed (MCE) is calculated as the arithmetic mean of the opening and closing capital employed in the year.
[8] 95.0% of SMP revenue is Openreach, with remainder 5% being Rest of BT
[9] Retail Price Index is a inflation index used to revalue non – current assets as part of our CCA methodology.

4. Review by Market Return

Market	Return £m	MCE £m	ROCE %	Return £m	MCE £m	ROCE %	Return £m	MCE £m	ROCE %
	2020/21			2019/20 Restated			2018/19 Restated		
Physical Infrastructure Access Market	368	5,165	7.1	352	4,943	7.1	340	4,782	7.1
Wholesale Local Access – FTTP	(332)	1,982	(16.8)	(231)	1,198	(19.3)	(99)	678	(14.6)
Wholesale Local Access – Legacy[10]	567	3,757	15.1	562	3,648	15.4	619	3,464	17.9
Business Connectivity Market	202	1,571	12.9	123	1,320	9.3	97	1,309	7.4
Openreach Narrowband Market	260	2,697	9.6	404	2,608	15.5	446	2,684	16.6
Rest of BT SMP Market	81	367	21.7	46	301	15.1	21	292	6.9
Total SMP	**1,146**	**15,539**	**7.4**	**1,256**	**14,018**	**8.9**	**1,424**	**13,209**	**10.8**

4.1 Physical Infrastructure Access (PIA) Market

PIA
Proportion of Total
SMP Return



Products

The PIA market is comprised of duct and poles i.e. the passive 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

	Internal Revenue £m	External Revenue £m	Total Revenue £m	Total Cost £m	Return £m	MCE £m	ROCE %	Return £m	MCE £m	ROCE %	Ofcom WACC %
	2020/21							2019/20 Restated			
PIA	710	2	712	344	368	5,165	7.1	352	4,943	7.1	7.1

Currently less than 1% of PIA revenue is external, although volumes continue to grow. Internal revenue is a notional "recharge" to downstream markets at cost plus an allowable return (7.1% of MCE). This treatment of PIA costs results by design in a ROCE of 7.1%, consistent with Openreach's cost of capital of 7.1%. As a result, we would not expect the return for PIA to diverge from Openreach's cost of capital of 7.1% in the future. The MCE has increased to £5,165m (2019/20 restated: £4,943m) as a result of continued investment in local duct for optical fibre.

[10] Legacy products includes FTTC and copper services such as Metallic Path Facilities (MPF).

4.2 Wholesale Local Access Markets

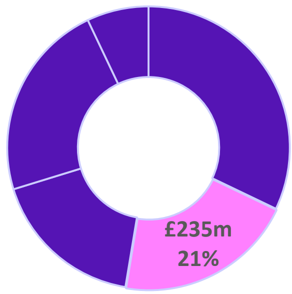
Products

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 (provided using Wholesale Line Rental, WLR) which may or may not be provided by the same CP.

WLA
Proportion of Total SMP Return



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 premise; and
- FTTP uses fibre all the way from the exchange to the premise.

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 7.9%. 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

	Revenue £m	Cost £m	Return £m	MCE £m	ROCE %	Revenue £m	Cost £m	Return £m	MCE £m	ROCE %	Ofcom WACC %
	2020/21					2019/20 Restated					
WLA	2,555	2,320	235	5,739	4.1	2,434	2,103	331	4,846	6.8	7.9/8.9[11]

During the year, ROCE has reduced to 4.1% from 6.8%. This was driven by a combination of declining returns in the copper market, alongside FTTP making up a significantly higher proportion of the total WLA asset base. Fibre-driven revenue increases were outstripped by a 10% rise in costs, primarily driven by a lower RPI annual increase generating much reduced CCA holding gains compared with 2019/20 and the increased costs associated with the higher FTTP asset base, higher engineer pay to support fibre roll out and special frontline bonus. MCE increased by 18%, primarily reflecting investment in the fibre network and increased cash and cash equivalents[12].

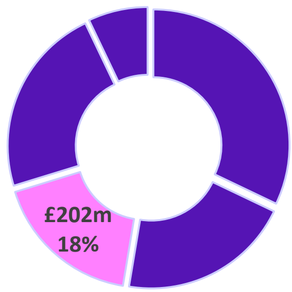
[11] Ofcom WACC is 7.9% for WLA Copper services and 8.9% for WLA Fibre services (Annex 20 of the 2018 WLA statement (28 March 2018)).
[12] Cash and cash equivalents are attributed based on the underlying attribution of opex and capex to services.

	Return £m	MCE £m	ROCE %	Return £m	MCE £m	ROCE %
	2020/21			2019/20 Restated		
FTTP	(332)	1,982	(16.8)	(231)	1,198	(19.3)
Legacy	567	3,757	15.1	562	3,648	15.4

Ofcom WACC is 7.9% on copper products, 8.9% on FTTX products. Legacy (copper and FTTC services) ROCE at 15.1% is higher than Ofcom WACC. When we make the adjustments Ofcom applied in its WLA charge control modelling (see note below)[13], ROCE is more consistent with Ofcom WACC. ROCE at (16.8)% is lower than WACC[14] for FTTP products as we invest in the network ahead of demand.

4.3 Business Connectivity Markets

Business Connectivity Proportion of Total SMP Return



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 include the following:

- Ethernet Access Direct (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 which use 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

	Revenue £m	Cost £m	Return £m	MCE £m	ROCE %	Revenue £m	Cost £m	Return £m	MCE £m	ROCE %	Ofcom WACC %
	2020/21					2019/20 Restated					
Business Connectivity Markets	818	616	202	1,571	12.9	720	597	123	1,320	9.3	8.0[15]

[13] Ofcom's adjustment in its 2018 WLA charge control modelling is not currently reflected in the methodologies we apply in the RFS. In the 2018 WLA charge control Ofcom calculated the common costs shared between copper and fibre services, and reallocated those costs based on a proportional basis of long run incremental costs of WLA and Openreach Narrowband services, resulting in a shift of common cost from copper services – both within the WLA and in the Narrowband Market – to FTTC .

[14] 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 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).

[15] Annex A21 of the 2019 PIMR and BCMR statement (28 June 2019).

ROCE for the Business Connectivity markets increased by 3.6 points to 12.9%, driven by a revenue increase of 14% resulting from higher demand for higher speed products. The resulting volume driven cost increases were partially offset by an increased allocation of costs to FTTP services and away from Business Connectivity services, in line with the increasing size of the FTTP asset base. MCE increased by £250m, primarily driven by higher cash and the first full year adoption of IFRS 16.

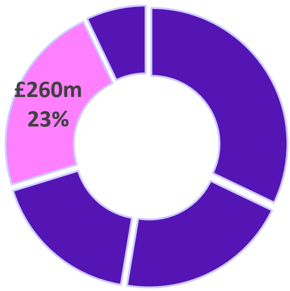
The Leased Lines Charge Control was published as part of the Business Connectivity Market Review 2019, and set prices at a safeguard cap of flat nominal pricing. Ofcom estimated that there may be some over or under recovery as a result of this. Our returns of 12.9%, although above Ofcom's estimated WACC of 8.0%, is within this range[16].

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.

Openreach Narrowband Proportion of Total SMP Return



Return

	Revenue £m	Cost £m	Return £m	MCE £m	ROCE %	Revenue £m	Cost £m	Return £m	MCE £m	ROCE %	Ofcom WACC %
	2020/21					2019/20 Restated					
Openreach Narrowband Markets	1,638	1,378	260	2,697	9.6	1,735	1,331	404	2,608	15.5	7.9

ROCE for the Narrowband markets fell 5.9 points to 9.6% (2019/20 restated: 15.5%). All products continued to see a decline in revenues, but increased costs, driven by a lower RPI annual increase generating lower CCA holding gains than in 2019/20. MCE increased 3%, reflecting higher cash[17] and the first full year adoption of IFRS 16 (see also section 2.1 above).

Returns are higher than the Openreach cost of capital of 7.9 used in Ofcom's charge control models. These services are in decline and the assets supporting them e.g. PSTN switches, are highly depreciated. Adopting Ofcom's approach and adjusting the assets' values on a HON (see footnote 1) basis the reported returns of 9.6% are reduced to 7.3%. The Narrowband Market also includes products such as ISDN Products provided after 30 November 2018 which are no longer price controlled (2017 Narrowband Market Review).

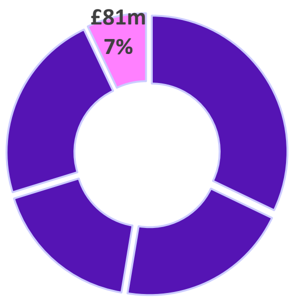
[16] Ofcom as detailed in A18.5 to the 2019 PIMR and BCMR statement considered a CPI-CPI charge control could lead to an recovery of costs up to £80m (13.0% ROCE) and an under recovery of up to £40m (5% ROCE) over the review period to March 2021.

4.5 Rest of BT SMP Markets

Products

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

Rest of BT Proportion of Total SMP Return



Return

	Revenue £m	Cost £m	Return £m	MCE £m	ROCE %	Revenue £m	Cost £m	Return £m	MCE £m	ROCE %	Ofcom WACC %
	2020/21					2019/20 Restated					
Rest of BT SMP Markets	304	223	81	367	21.7	259	213	46	301	15.1	11.0

ROCE for Rest of BT SMP Markets increased 6.6 points to 21.7% driven by increased WBA bandwidth revenues. The equipment in this market is heavily depreciated and the book returns do not represent a steady state.

Returns are in excess of the Ofcom WACC for these markets (11%) driven by high returns in WBA Market A, resulting from heavily depreciated equipment, and higher bandwidth demand. WBA has been deregulated since 1 April 2021 and will no longer be reported as part of the RFS in 2021/22.

Disclaimer

This document contains BT's commentary on the Regulatory Financial Statements (RFS) for the year ended 31 March 2021. 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.