

BT GROUP PLC
Form 6-K
June 01, 2005

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 6-K

Report of Foreign Private Issuer

Pursuant to Rule 13a-16 or 15d-16 of
the Securities Exchange Act 1934

Report on Form 6-K dated June 1, 2005

BT Group plc

(Translation of registrant's name into English)

BT Centre
81 Newgate Street
London EC1A 7AJ
England

(Address of principal executive offices)

Indicate by check mark whether the registrant files or will file annual reports under cover of Form 20-F or Form 40-F.

Form 20-F Form 40-F

Indicate by check mark whether the registrant by furnishing the information contained in this Form is also thereby furnishing the information to the Commission pursuant to Rule 12g3-2(b) under the Securities Exchange Act of 1934.

Yes No

This Report on Form 6-K is incorporated by reference into the registrant's Annual Report on Form 20-F for the year ended March 31, 2005 (Commission file number 1-8819).

Enclosure: BT Group plc - Annual Report and Form 20-F 2005

This Report contains the Annual Report and Form 20-F 2005 of BT Group plc (the "Company") for the fiscal year ended March 31, 2005. The Annual Report and Form 20-F 2005 comprises the Annual Report and accounts of the Company in accordance with United Kingdom requirements and the information required to be set out in the Company's Annual Report on Form 20-F for the fiscal year ended March 31, 2005 (the "Form 20-F") to the Securities and Exchange Commission. The information in the Annual Report and Form 20-F 2005 that is referenced in the "Cross reference to Form 20-F" table on pages 141 to 143 of the Annual Report and Form 20-F 2005 shall be deemed to be filed with the Securities and Exchange Commission for all purposes, including incorporation by reference into the Company's Annual Report on Form 20-F filed with the Securities and Exchange Commission on June 1, 2005.

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BT is one of the world's leading providers of communications solutions serving customers in Europe, the Americas and Asia Pacific. Its principal activities include networked IT services, local, national and international telecommunications services, and higher-value broadband and internet products and services. In the UK, BT serves over 20 million business and residential customers, as well as providing network services to other operators.

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BT Group plc is a public limited company registered in England and Wales, with listings on the London and New York stock exchanges.

This is the annual report for the year ended 31 March 2005. It complies with UK regulations and is the annual report on Form 20-F for the Securities and Exchange Commission to meet US regulations.

This annual report has been sent to shareholders who have elected to receive a copy. A separate annual review and summary financial statement for the year ended 31 March 2005 has been issued to all shareholders.

In this annual report, references to "BT Group", "BT", "the group", "the company", "we" or "our" are to BT Group plc (which includes the continuing activities of British Telecommunications plc) and its subsidiaries and lines of business, or any of them as the context may require.

References to the "financial year" are to the year ended 31 March of each year, eg the "2005 financial year" refers to the year ended 31 March 2005. Unless otherwise stated, all non-financial statistics are at 31 March 2005.

Please see cautionary statement regarding forward-looking statements on page 128.

BT was incorporated in England and Wales on 30 March 2001 as Newgate Telecommunications Limited with the registered number 4190816. The company changed its name to BT Group plc on 11 September 2001. Following the

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demerger of O2 in November 2001, the continuing activities of BT were transferred to BT Group.
BT Group's registered office address is 81 Newgate Street, London EC1A 7AJ.

BT Group plc Annual Report and Form 20-F 2005

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- Group turnover of £18.6 billion
- New wave turnover of £4.5 billion, up 32%
- Profit before taxation, goodwill amortisation and exceptional items of £2.1 billion, up 4%
- Earnings per share before goodwill amortisation and exceptional items of 18.1 pence, up 7%
- Net debt reduced from £8.4 billion to £7.8 billion
- Dividends of 10.4 pence per share for the year, up 22%

Years ended 31 March
In £ million unless otherwise stated

	2005	2004 ^a	2003 ^a
Group turnover	18,623	18,519	18,727
Exceptional operating costs	(84)	(33)	(48)
Total operating profit	2,764	2,836	2,905
Profit on sale of fixed asset investments	358	38	1,705
Loss on sale of group undertakings	□	(2)	(9)
Profit on sale of property fixed assets	22	14	11
Profit before taxation	2,343	1,945	3,173
Profit after taxation	1,820	1,406	2,714
Basic earnings per share	21.4p	16.4p	31.4p
Dividends per share	10.4p	8.5p	6.5p
Profit before goodwill amortisation, exceptional items and taxation	2,085	2,013	1,840
Basic earnings per share before goodwill amortisation and exceptional items	18.1p	16.9p	14.4p
Net cash inflow from operating activities	5,898	5,389	6,023
Capital expenditure on property, plant and equipment	3,011	2,673	2,445

^a Restated following the adoption of UITF17 and UITF38 (see note 1 on page 81)

The financial information above is discussed in the Financial review on pages 25 to 43, together with the reasons for focusing on the results from continuing activities before goodwill amortisation and exceptional items.

The Consolidated financial statements are on pages 71 to 122.

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Chairman's message

Our results for the 2005 financial year were strong. New wave revenues grew by 32% to £4.5 billion, and now represent nearly a quarter of our business. Earnings per share have more than doubled over the past three years and net debt is more than £20 billion lower than in 2001.

Earnings per share in the 2005 financial year, before goodwill amortisation and exceptional items, grew by 7% to 18.1 pence. While continuing to invest for the future, we generated free cash flow of £2.3 billion, up 10%.

The news on dividends is positive. We are recommending a full-year dividend of 10.4 pence per share, a pay out ratio of 57% of earnings before goodwill amortisation and exceptional items, compared to 50% last year. We continue with our progressive dividend policy. The dividend for the 2006 financial year will be at least 60% of underlying earnings: subject to the group's overall financial position, we expect our pay out ratio to rise to around two-thirds of underlying earnings by the 2008 financial year.

We continued with our share buy back programme in the 2005 financial year. This is being funded from cash generated over and above that required for servicing our debt. We have reduced net debt to below £8 billion, a level with which we are comfortable.

Business progress

In support of our strategy for transformation and growth, your Board gave backing during the year for a targeted series of acquisitions that will help to build our capabilities as one of the world's foremost global networked IT services companies. These acquisitions offered value for money, had a compelling strategic fit and brought capabilities to strengthen BT globally. In addition, passing the five million mark for broadband connections in the UK in early April was a key moment in the history of your company.

Regulation

BT welcomed the Strategic Review of Telecommunications by Ofcom. During the year we have worked to help influence and shape their thinking and made a radical proposal for a new regulatory landscape in the UK. We continued to argue strongly that structural separation was not in shareholders' or customers' interests. We look forward to the published outcome. Our position remains that a strategic and flexible regulatory regime, together with rapid deregulation wherever possible, is vital to meeting customers' developing needs and creating the conditions in which we, and others, can continue to invest with confidence.

Board membership

There were a number of changes to your Board during the 2005 financial year. I would like to welcome Hanif Lalani as our new Group Finance Director. Ian Livingston, who had occupied the finance role with distinction for three years, was appointed Chief Executive BT Retail with effect from February 2005. It is a testament to the strength of BT's management team generally that we were able to appoint people from inside the company to such key roles. I would also like to thank Pierre Danon, who left the Board in February, for his significant contribution as Chief Executive of BT Retail for the last four years.

Wider responsibilities

It is increasingly important that companies such as BT continue to be good corporate citizens, living up to our responsibilities to the communities in which we operate and to the environment. I'm proud to be able to report that, for the fourth year in a row, BT was the highest placed telecommunications company in the Dow Jones Sustainability Index. Our community programmes focus on those issues where communications really can make the difference; we have provided long-term support, for example, for a drama-based education programme to help develop young people's communications skills, and for the work of the children's charity ChildLine.

Like so many other companies and individuals, we wanted to respond to the devastating Asian tsunami in December 2004. We made a donation of £500,000 to the Disasters Emergency Committee (DEC) and we provided a live call centre for the unprecedented number of calls coming into the DEC. I'm particularly proud of the fact that so many of our employees were involved in fundraising activities and that 16 of our engineers travelled to the affected area to help re-establish communications.

Outlook

The process of transformation on which your company embarked in 2001 is accelerating. That process is increasingly reflected in your company's results. We are well set for further success in the years ahead.

I'd like to thank shareholders for the loyalty they've shown. Your continued confidence – coupled with the loyalty of our customers and suppliers and the imagination and commitment of our employees – is fundamental to our transformation for growth.

Sir Christopher Bland

Chairman
18 May 2005

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Chief Executive's statement

Today, BT is a very different company from the one that I joined three years ago. As our customers' needs have changed and continue to change, so we have found and continue to find new ways of meeting those needs, investing in innovative products and services which add value to our customers and to BT. That, after all, is what being a service company means.

In 2005, convergence is at the heart of BT's strategy.

By convergence, we mean the ability to bring together our capabilities and capacities in new ways to make life better, simpler and cheaper for our customers. For our business customers this means productivity improvements; for consumers it's about new, easier to use services. For customers of all kinds it means a more joined-up communications experience.

So, for example, we offer our major corporate customers around the world a unique marriage of our networking experience and infrastructure with IT services. These used to be separate offerings, often supplied by different companies, but we're bringing them together in one place. This means that however much their operations are dispersed around the globe, our customers can communicate and operate as one, anytime, anywhere, and at lower cost.

What we're doing in the mobile market is similarly about convergence – we aim to offer customers a converged combination of – the best of fixed and the best of mobile. Ultimately, our customers shouldn't have to worry about fixed or mobile when what they really want is freedom and flexibility. This means that we have to find ways of helping them communicate, wherever they are, using whatever device they choose, at the right price.

And convergence is also what our twenty-first century network (21CN) programme is all about. What our customers need to know is that the 21CN can support a range of technologies and services that will enable them to do the things they want to do – faster, more seamlessly and more cost efficiently. And because this new network will support a wide range of innovative services which are currently run on separate networks, it will be much more cost efficient for BT.

Global networked IT services

We have raised our global profile through targeted acquisitions, including Infonet and Radianz, and by increasing our holding in Albacom to 100%.

We continued to play to our strengths in the networked IT services market. A few years ago, our position in this market was aspirational; today, we are competing with the best – and winning. The BT brand is now a powerful presence in the global networked IT services market. It's a brand that stands for excellent networking skills and a genuine commitment to finding innovative ways of delivering what our customers want, end to end, leaving them free to do what they're good at: running their businesses.

Our ICT (information and communications technology) revenues were £3 billion in the year and the major contracts we've won indicate the confidence that our customers are prepared to put in us. We now have a track record of meeting the needs of public and private sector customers in, for example, the financial services and government arenas.

Our networked IT services order intake for the year was over £7 billion.

Broadband

Broadband has been an enormous success story, not just for BT but for the UK as a whole, which now has the highest levels of broadband access of any country in the G7 group of nations. We hit our five million broadband lines target a year early.

As broadband access becomes a fact of life for most people in the UK, our focus is shifting further towards the retail market where we have fantastic scope to drive further growth.

Having got broadband, people now want to do more and more with it. We are increasing speeds by up to four times at no extra cost to our retail customers.

Convergent mobility services

The launch, in partnership with Vodafone, of our mobile virtual network operator in both the business and consumer markets is the key to building a mobility customer base and a path to mobile convergence. We now have over 372,000 contract connections.

Our strategy is to build a foundation for the delivery of high-value, fixed/mobile convergent solutions, for consumers and businesses. An early example of this will be Project Bluephone which will give customers the convenience of a mobile phone with the quality and cost advantage of fixed-line services.

Twenty-first century network

Our 21CN will help to make the UK one of the most advanced telecommunications countries in the world, transform our wholesale business and support the next generation of flexible, cost-efficient services. At the end of April 2005, we announced the eight preferred suppliers who will help us to implement the 21CN.

The capital expenditure involved is significant but the 21CN will lead to a radical simplification of our networks making it easier to offer compelling propositions to all our customers. The real challenge is to ensure that we invest in a way that meets customers' needs.

Traditional business

We are experiencing major changes in our traditional markets as a result of regulation, growing competition and significant shifts in our customers' buying patterns, as they discover the possibilities of technologies such as instant messaging and voice over IP.

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Fixed-voice telephone calls may no longer be the only way to measure the success of a communications company, but they remain fundamental to our business. We may have lost some market share to competitors but we will continue to compete aggressively by offering new and better services, and improved customer value.

Cost efficiency

Taking a leadership position on costs is critical. Earnings per share is a key measure, which means that we have to continue to look at every cost line in the business and challenge it. We've made excellent progress on improving our cost efficiency in the past few years and in the 2005 financial year, our cost efficiency programmes achieved savings of around £400 million, and we aim to deliver at least £300 million to £400 million of savings in each of the next three years.

Relentless customer focus

Our 20 million customers are a wonderful asset and we have to continue to show how much we value every one of them.

A key target for us was driving down customer dissatisfaction – we've reduced dissatisfaction levels by 23% on a compound annual basis over the past three years. There is still more to be done and we must continue this focus.

Our people

People bring strategies to life, people deliver world-class customer experiences, people make convergence happen.

Two years ago, we introduced our new brand values – trustworthy, helpful, inspiring, straightforward, heart.

Since then, BT people have embraced these values, and turned the business inside out and upside down to deliver our strategy, finding innovative ways to reinvent BT in our traditional markets at the same time as establishing our BT brand in new markets, all the while driving down customer dissatisfaction.

I am constantly amazed by their commitment and by what they have achieved.

Ben Verwaayen

Chief Executive
18 May 2005

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Operating and financial review

Business review

The Business review is divided into the following sections:

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- 9 Build on our networked IT services capability**
- 10 Deliver on broadband**
- 11 Create convergent mobility solutions**
- 12 Defend our traditional business vigorously**
- 13 Drive for cost leadership**
- 13 Keep a relentless focus on improving customer satisfaction**
- 13 Transform our network for the twenty-first century**
- 13 Motivate our people and live the BT values**
- 14 Research and development and IT support**
- 15 Property**
- 15 Regulation, competition and prices**
- 22 Relationship with HM Government**
- 22 Legal proceedings**

[Please see cautionary statement regarding forward-looking statements on page 128.](#)

All customer numbers are given as at 31 March 2005, unless stated otherwise.

The definition, reconciliation and reasons for disclosing EBITDA (earnings before interest, taxation, depreciation and amortisation) are discussed in the **Financial review**.

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Introduction

BT Group plc is the listed holding company for an integrated group of businesses, which together form one of the world's leading providers of communications solutions serving customers in Europe, the Americas and the Asia Pacific region. British Telecommunications plc is a wholly-owned subsidiary of BT Group plc and holds virtually all businesses and assets of the BT group.

Our aim is to increase shareholder value through service excellence, an effective brand, our large-scale networks and our existing customer base, and also through innovation in products, services and solutions. Our principal activities include networked IT services; local, national and international telecommunications services; and higher-value broadband and internet products and services.

In the UK

BT is the UK's largest communications service provider, by market share, to the residential and business markets, supplying over 20 million customers with a wide range of communications products and services, including voice, data, internet and multimedia services, and offering a comprehensive range of managed and packaged communications solutions.

Our core portfolio covers traditional telephony products such as calls, analogue/digital lines and private circuits. New wave revenue generation is focused on networked IT services, broadband and mobility.

In the UK wholesale market, we provide network services and solutions to over 600 communications companies, including fixed and mobile network operators, ISPs (internet service providers) and other service providers. We interconnect with more than 180 other operators, as well as carrying transit traffic between telecommunications operators.

Our aim in these markets is to continue to increase profitable revenues from data and advanced broadband and internet services, further reducing our dependence on revenues and profit generated by traditional fixed-line voice services.

In the 2005 financial year, 91% of our revenues were derived from operations within the UK.

Globally

We supply managed services and solutions to multi-site organisations worldwide – our core target market is 10,000 multi-site organisations including major companies with significant global requirements, together with large organisations in target local markets. We provide them with global reach and a complete range of networked IT services.

Our extensive global communications network and strong partnerships enable us to serve customers in the key commercial centres of Europe, North America and the Asia Pacific region. We own operations in the Americas, Africa, the Asia Pacific region, Belgium, France, Germany, Ireland, the Netherlands, Spain, Italy, Scandinavia, Switzerland and Central and Eastern Europe. In a small number of countries we use a combination of direct sales and services capabilities and strategic partners to deliver the services our customers want. We currently have employees in 12 countries in Asia Pacific, and operate multiple sales offices in the Americas.

Our global communications services portfolio includes: desktop and network equipment and software; transport and connectivity; managed LAN (local area network), WAN (wide area network) and IPVPN (internet protocol virtual private network) services; managed mobility; applications hosting; storage and security services; and business transformation and change management services.

Governance

BT's policy is to achieve best practice in our standards of business integrity in all our operations, in line with our published statement of business practice – *The Way We Work*. This includes a commitment to maintaining the highest standards of corporate governance throughout the group (see **Corporate governance**).

Corporate social responsibility

We are committed to enhancing our positive impact on society through leadership in CSR (corporate social responsibility). In our view, a well managed CSR programme supports the delivery of strategy and is in the best interests of customers, shareholders, employees and the community (see **Our commitment to society**).

Ofcom's Strategic Review of Telecommunications

Shortly after assuming its regulatory functions in December 2003, the Office of Communications (Ofcom) began conducting a Strategic Review of Telecommunications, the aim of which is to consider the scope for the further

development of effective competition in the telecommunications sector.

The Review has found that although the UK telecommunications market has delivered significant benefits for consumers and businesses, the current market situation is not acceptable or desirable going forward.

Consequently, Ofcom's second consultation put forward three options:

withdrawal from regulation in favour of reliance on competition law;

a market investigation reference to the Competition Commission under the Enterprise Act; or

the delivery by BT to other industry participants of "real equality of access".

BT supports the concept of a settlement based on equality of access which would, in our view, be an ideal opportunity to focus regulation on economic bottlenecks and reduce it elsewhere; sweep away the "regulatory mesh" that has grown up since 1984; and deliver regulatory stability and certainty, promoting the confidence that market participants need if they are to invest and innovate. Consequently, in our response to Ofcom's second consultation we put forward a package of proposals under which BT would make significant organisational and other changes to address issues of market confidence and transparency. We stressed that as part of this package, we would need Ofcom to take certain measures, notably to make a commitment to rapid and significant deregulation.

Ofcom is currently involved in discussions with BT and others aimed at assessing whether a settlement based on equality of access would be feasible. If it concludes it is not, it will consider adopting the second of the three options outlined above, ie an Enterprise Act reference.

See **Regulation, competition and prices** for more information on Ofcom's proposals and BT's response.

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Group structure

Background

British Telecommunications plc, the successor to the statutory corporation British Telecommunications, was incorporated in England and Wales as a public limited company, wholly owned by the UK Government, as a result of the Telecommunications Act 1984. Between November 1984 and July 1993, the UK Government sold all of its shareholding in three public offerings.

In the 2002 financial year, BT undertook a radical restructuring, including the UK's largest-ever rights issue (raising £5.9 billion), the demerger of O2 (comprising BT's wholly-owned mobile assets in Europe), the disposal of significant non-core businesses and assets, the unwind of Concert (BT's joint venture with AT&T) and the creation of customer-focused lines of business.

Acquisitions and disposals prior to the 2005 financial year

In the 2003 financial year, we completed the sale of our 26% stake in Cegetel Groupe SA, the leading alternative fixed-line operator in France, for £2.6 billion in cash. In addition, we disposed of a number of non-core investments, including our stakes in BSKyB, Mediaset, Blu and SmarTone.

In the 2004 financial year we sold our stake in Inmarsat, a global mobile satellite communications services company, and monetised our shareholding in LG Telecom, a wireless telecommunications service provider in the Republic of Korea. We also acquired the UK operations of NSB Retail Systems, a supplier of software products and services, and Transcomm, a provider of data-only wireless services in the UK.

Acquisitions and disposals in the 2005 financial year

In February 2005, we completed the acquisition of Infonet, one of the world's leading providers of international managed voice and data network services, for £520 million, including acquisition costs. Excluding Infonet's net cash balance, the net value of the deal was £315 million.

The acquisition of Infonet, re-branded BT Infonet, is a significant step forward in our strategy of addressing the networked IT services needs of multi-site organisations. It will significantly extend our global reach and will deepen our presence in North America and the Asia Pacific region. BT Infonet has local operations and/or distributors in 70 countries, remote network access in approximately 180 countries and strong sales and support partnerships around the world.

Also in February 2005, we acquired the 74% of Albacom that we did not already own from our three joint venture partners – ENI, BNL and Mediaset – for a minimum of £80 million. Including acquisition costs, and settlement of BT's share of Albacom's bank loan, the total acquisition cost was £131 million. BT has been active in the Italian business communications market since 1995 and Albacom provides data transmission, voice and internet services to more than 170,000 customers in that market. We also signed outsourcing contracts with our former joint venture partners.

In October 2004, there was an IPO (initial public offering) of the Singapore telecommunications and media company, StarHub, in which BT held an 11.9% stake. By November 2004, we had disposed of our entire holding, through the IPO, for £78 million in cash.

Also in October 2004, we acquired BIC Systems Group Limited for a cash consideration of £17 million, consolidating our position in the networked IT services sector in Northern Ireland.

In December 2004, we completed the sale of our 15.8% stake in Eutelsat to GS Capital Partners – an investment partnership affiliated with Goldman Sachs – for £357 million in cash. In January 2005, we completed the sale of our 4% stake in Intelsat to a consortium of private equity investors for £65 million in cash. This followed the sale in June 2004 of our 4.8% stake in New Skies Satellites for £24 million in cash.

In July 2004, we disposed of our 27.7% stake in PayPoint Limited, a bill payment collection network operator, to various institutional investors for £34 million in cash.

Post balance sheet acquisitions

In April 2005, we completed the acquisition of Radianz, the leading financial services extranet provider, from Reuters for a cash consideration of £107 million. The purchase of Radianz is another vital step in our transformation into a global provider of networked IT services. Radianz will continue to provide high-quality extranet services for Reuters and the global financial services market.

How BT operates

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BT consists principally of three lines of business: BT Retail, BT Wholesale and BT Global Services.

BT Retail and BT Wholesale operate almost entirely within the UK, addressing the consumer, business and wholesale markets, and offer a broad spectrum of communications products and services.

BT Global Services addresses the networked IT services needs of multi-site organisations including major companies with significant global requirements and large organisations in target local markets.

Further analysis of group turnover is provided in the **Financial review**.

Consumer customers

As at 31 March 2005, BT had approximately 19 million UK consumer customers with around 20 million residential customer lines (exchange line connections). In the 2005 financial year, consumer revenues declined by 6% to £5,637 million, primarily reflecting the impact of CPS (carrier pre-selection) and regulatory price reductions to mobile termination rates.

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Our strategy in the consumer market is to defend traditional revenues and market share vigorously through innovative service offerings backed by innovative marketing and excellent quality of service. At the same time, we are driving for new wave revenues, particularly in the areas of broadband and mobility.

In the consumer market, new wave revenues grew by 85% from £223 million in the 2004 financial year to £412 million in the 2005 financial year, driven principally by broadband and mobility. Residential broadband customers increased by 96% in the year to more than 1.3 million and mobility connections increased to 187,000 as at 31 March 2005.

Major corporate and business customers

As at 31 March 2005, we had around 1.5 million business customers worldwide, with nine million exchange lines in the UK.

In the 2005 financial year, major corporate revenues increased by 4% to £6,101 million. The increase in new wave turnover of 19% to £2,926 million was driven by networked IT services, broadband and by mobility, not only in the UK but also globally.

Our strategy in the major corporate market is to continue to migrate from traditional voice-only services to networked IT services. This enables us to build closer, more integrated, long-term, high-value relationships with our customers, enabling them to manage their communications spend more effectively and gain competitive advantage in their markets. Such relationships will, we believe, deliver long-term, sustainable, predictable and profitable revenues, more than offsetting the decline in our traditional business revenues. As at 31 March 2005, new wave turnover accounted for 48% of our total turnover in the major corporate market.

In the SME market (typically companies with up to 500 employees), our strategy is to provide business customers with tailored communications products and services that enable them to manage their businesses more simply and efficiently. Overall, in the SME market during the 2005 financial year, revenues reduced by 5% to £2,464 million primarily reflecting the impact of CPS and WLR (wholesale line rental).

Wholesale customers

Our strategy in the UK wholesale market is to continue to generate profitable revenues from our core market and from new wave products in broadband, networked IT services and mobility.

In the 2005 financial year, turnover from our wholesale activities increased by 9% to £4,396 million.

In the UK, external turnover from BT's wholesale activities was £3,812 million in the 2005 financial year, compared with £3,473 million in the 2004 financial year.

New wave revenues were £664 million, up 84% on the 2004 financial year. This increase was driven by the success of broadband as well as a strong emphasis on customers as we aim to build innovative solutions that help our wholesale customers grow their businesses.

In our global carrier business, revenues were £584 million in the 2005 financial year, compared with £557 million in the 2004 financial year. Our global carrier business customers include other fixed-line telecommunications operators, mobile operators and selected ISPs.

Report structure

For the purposes of this **Business review**, we are reporting on each of our strategic imperatives.

For financial reporting purposes, we continue to report by line of business (see **Financial review**).

Group strategy

Our strategy is to build long-term partnerships with our customers. With their support, we aim to maximise the potential of our traditional business through a combination of enhanced quality of service, creative marketing, innovative pricing and cost efficiency while pursuing profitable growth by migrating our customers to new wave products and services such as networked IT services, broadband, mobility and managed services.

We are also exploring new ways of doing business and have, for example, set up a number of ventures to deliver new revenue streams by taking an innovative and entrepreneurial approach to our core business.

We have eight strategic imperatives, five of which are focused on generating new wave revenues, defending revenue in traditional markets and operating with maximum efficiency:

build on our networked IT services capability
deliver on broadband
create convergent mobility solutions
defend our traditional business vigorously
drive for cost leadership.

These are underpinned by three further imperatives:
keep a relentless focus on improving customer satisfaction
transform our network for the twenty-first century
motivate our people and live the BT values.

Build on our networked IT services capability

Our strategy in the networked IT services market is to reinforce BT's position as a global player capable of competing with the world's best in selected growth markets. Our portfolio of services covers a number of key areas including IP infrastructure, CRM (customer relationship management), security, applications, managed mobility, hosting, and outsourcing.

Networked IT services for major corporate customers

As business applications are increasingly being networked, networks are seen as increasingly vital to productivity and competitive advantage.

ICT revenues for the 2005 financial year were £2,753 million, a rise of 18% on the 2004 financial year. We aim to deliver networked IT services globally to large business customers and other organisations (including the public and government sectors), giving them the communications tools they need for productivity and/or business improvement.

In the 2005 financial year, we secured networked IT services orders worth more than £7 billion. Major contracts included:

Our highest profile success in the global market came in March 2005 when it was announced that BT will be Reuters's supplier of network services under a contract expected to be worth up to £1.5 billion over eight and a half years. BT will provide and manage secure data networks for Reuters's products and services worldwide. We also signed a new voice and data communications deal with Barclays plc to provide enhanced communications infrastructure services for Barclays's

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UK operations. The value of these services, including existing business, is expected to be in excess of £500 million over the seven-year term.

A number of contract wins during the 2005 financial year helped to confirm BT's European credentials and capability. For example, we signed an outsourcing contract with French company THALES Group, an international electronics and systems group serving the defence, aeronautics, security and services markets. The five-year contract covers the management of fixed-voice and data network services for THALES and its subsidiaries in up to 42 countries.

We signed a multi-year managed services agreement with Bristol-Myers Squibb to manage its LAN and WAN infrastructure globally. As part of the agreement, BT will migrate these services to a state-of-the-art, high-speed, IP-based global MPLS (multi-protocol label switching) infrastructure.

We were awarded a global network outsourcing contract with South Korea-based CyberLogitec, the IT subsidiary of Hanjin Shipping. With a sales order value of £18 million, this is one of the largest contracts won by BT in the Asia Pacific region.

National Air Traffic Service awarded us a £32 million contract to provide a system to carry all communications between its radar, communication and air traffic control centre sites and its IT network.

In addition to the range of large deals, we secured more than 300 networked IT services contracts each worth between £1 million and £5 million during the 2005 financial year.

In April 2005, we won an extension to 2012 of a contract to deliver essential telecommunications services to the Ministry of Defence (MoD) and the UK's armed forces. Between April 2005 and July 2012, the Defence Fixed Telecommunications Systems public/private partnership contract between the MoD and BT will be worth up to £1.5 billion, bringing the total value of the contract to more than £2.7 billion.

We underlined our position as a global networked IT services company with the launch of a major business-to-business advertising and marketing campaign in September 2004. The campaign ran in multiple languages in international and local media across Europe, the Americas and the Asia Pacific region.

Networked IT services for wholesale customers

We believe that the convergence of IT and communications technologies creates commercial opportunities for communications providers, and our strategy is to enable these providers to take full advantage of such opportunities.

We have a long and successful tradition of delivering network-based connectivity to the carrier and intermediate telecommunications markets throughout the UK, and have developed value-enhancing services and solutions. We have a number of agreements with service providers and mobile operators to upgrade their IP capability. In addition, we have used our expertise and geographic reach to provide ubiquitous, bespoke data housing solutions.

Our plans for our twenty-first century network (21CN) will enable the delivery of further integrated network and communications solutions to our customers and their end-user customers.

Deliver on broadband

In the 2005 financial year, we continued our drive to enhance the awareness, availability and attractiveness of broadband and we are on target to bring broadband to exchanges serving 99.6% of UK homes and businesses by the summer of 2005. The UK now has the most extensive broadband network of all the countries in the G7 Group, according to telecommunications analyst Ovum.

We believe that the key issues in today's broadband markets are speed and price, but that, going forward, applications will increasingly prove to be a competitive differentiator.

Broadband for wholesale customers

In early April 2005, we reached our target of five million broadband lines, one year ahead of schedule. Since we first announced the target, take-up has continued to accelerate – whereas it took a year to reach our first million, the fifth million took just four months. Since September 2004, we have been connecting someone to broadband every ten seconds of every day. In total, 4,419 exchanges had been upgraded by the end of the 2005 financial year, reaching almost 97% of the UK's homes and businesses. Broadband is now one of the fastest growing consumer products of all time.

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In February 2005, Northern Ireland became the first UK region outside London to have all its exchanges enabled for broadband. As at 1 March 2005 □ as a result of a £10 million partnership between BT and One Northeast, the regional development agency for northeast England □ all 181 exchanges in the region had been upgraded. In April 2005, we won the £16.5 million public tender with the Scottish Executive to bring broadband to the most remote communities in the UK. We will enable 378 exchanges to deliver broadband to 51,000 households and 5,400 businesses.

During the 2005 financial year, we removed the distance-related limits on our most popular broadband services, bringing around one million more UK homes and businesses within reach of broadband.

As the broadband market has matured, new applications, including video and music downloads and videoconferencing, have driven a demand for increasing speed. Since April 2005, we have been testing speeds of between 2Mbit/s and 8Mbit/s with a

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view to launching higher-speed wholesale services in the second half of 2005. In addition, we are trialling a variant of ADSL (asynchronous digital subscriber line) broadband, known as ADSL2+, which may support speeds of more than 20Mbit/s.

With effect from April 2005, we reduced the wholesale cost to service providers of our BT IPStream and BT DataStream ADSL products by an average of 8% in areas of high demand.

We also announced details of the next 500 exchanges to be upgraded to provide SDSL (synchronous digital subscriber line) services. SDSL offers the same rate upstream and downstream and is particularly suitable for the SME market. By April 2006, we aim to SDSL-enable 1,300 exchanges, covering more than two thirds of UK businesses.

During the 2005 financial year, we redesigned and reduced the price for our LLU (local loop unbundling) product (see **Regulation, competition and prices** □ **Local Loop Unbundling**) by up to 70% in a phased series of price cuts which will, we believe, make it easier for LLU operators to invest in broadband infrastructure with confidence. As at 31 March 2005, LLU operators were providing service to 40,000 lines from more than 600 exchanges, many of which were multi-operator sites.

Broadband for consumers

As at 31 March 2005, in the highly competitive retail market, our share of consumer and business DSL broadband connections in the UK was 36% (1.75 million connections).

BT is the UK's leading service provider of broadband, offering a family of broadband packages designed to meet the diverse needs of our customers. Key packages include BT Broadband Basic and BT Broadband which offer rapid, always-on internet access; BT Yahoo! Broadband which also provides a fuller range of benefits, including multiple email addresses, virus protection, personalised music, parental controls, protection against unsolicited email and evolving applications and content; and BT Communicator with Yahoo! Messenger.

We transformed our retail broadband offering, by announcing the transfer of our customers to a new super-fast standard, beginning in February 2005. Most consumer and business customers will have their broadband speed increased to up to 2Mbit/s □ up to four times faster than previous speeds □ at no extra cost. The introduction of 2Mbit/s as standard will enable customers to get more from their broadband link and paves the way for a range of new services.

BT will also use broadband to make new services, such as video on demand and interactive TV, available to customers.

In July 2004, we launched BT Communicator with Yahoo! Messenger. This integrated software package, downloadable from the internet, gives customers a truly convergent, multi-media communications experience, enabling them to manage all their home communications □ phone calls, emails, texts, instant messaging and webcam □ together in one place on their PC.

Broadband for business customers

We believe that the introduction of 2Mbit/s ADSL broadband as standard will help business customers maximise the major opportunities offered by online trading and teleworking.

BT Business Broadband remained the leading ISP for SMEs in the UK. At the end of the 2005 financial year, we had over 340,000 BT Business Broadband customers and were adding 250 a day. More than half opt for such value-added services as the Internet Security Pack and the Internet Business Pack.

In January 2005, we created an online payments business by bringing together BT Click&Buy and our online card payment service, BT Buynet, which currently process almost 17 million transactions a year between them. The new business will offer an extensive range of payment solutions to the rapidly growing online retail market. BT Business Broadband Voice, launched in November 2004, gives small businesses throughout the UK access to VOIP (voice over IP) services and enables them to use their broadband connections to reduce costs for multiple business lines. On average, BT Broadband Voice offers customers savings of more than 60% compared with second line rental.

Create convergent mobility solutions

In a convergent world, individuals and businesses increasingly need to connect and communicate whenever and wherever they happen to be, using whatever devices they choose.

Our aim is to offer all our customers the right combination of the quality, reliability, cost advantages and bandwidth associated with fixed-line communications, and the convenience, personalisation and mobility associated with mobile communications.

In the 2005 financial year, we launched BT Mobile as an MVNO (mobile virtual network operator) running over the Vodafone network. Becoming an MVNO is fundamental to building our mobility customer base, driving the

wireless broadband market and developing and delivering compelling convergence propositions and one converged customer experience.

Project Bluephone is a converged mobile service, enabling customers to use a single device that can switch seamlessly between fixed and mobile networks. This will provide customers with the convenience of mobile combined with the cost and quality advantages of a fixed-line phone. We plan to launch Project Bluephone shortly.

We believe that a partnership strategy is fundamental to our success and we are working hard through the FMCA (Fixed Mobile Convergence Alliance) to develop open industry standards and through the WBA (Wireless Broadband Alliance) to drive Wi-Fi (public wireless broadband) hotspot proliferation, global roaming and user satisfaction.

Revenue in the mobility market in the 2005 financial year was £205 million, an increase of 107% on the 2004 financial year.

As at 31 March 2005, BT Mobile had over 372,000 business and consumer connections.

Mobility for consumers

In the consumer mobility market our strategy is to build a foundation for the delivery of added-value, fixed/mobile convergent solutions.

In January 2005, we launched BT Mobile as an MVNO with Vodafone in the consumer market. BT Mobile is cost-effective for families, offering up to five additional

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handsets. Other benefits include free short calls from a BT Mobile phone to a designated home number and a single consolidated mobile bill.

Mobility for business customers

BT is a service provider in the business mobility market with more than 185,000 business connections at 31 March 2005. We provide a range of managed mobile services to UK and global customers who either outsource their mobile communications entirely or rely on BT to provide specific managed services.

In November 2004, we launched our BT Mobile MVNO business in the SME and corporate market, offering a range of mobile services including a mobile VPN service (BT Business Circle) and mobile conferencing.

We are a leading UK provider of Wi-Fi services. BT Openzone offers customers a high-speed, wireless broadband connection over which they can access the internet, send and receive emails with attachments and connect to a corporate network. As at 31 March 2005, our customers had access to more than 7,500 hotspots throughout the UK and more than 20,000 globally.

Mobility for wholesale customers

In the 2005 financial year, we continued to implement our strategy in the UK wholesale mobile arena to maximise the volume and value of wireless traffic by developing and launching innovative products and services.

For example, we launched Fixed Line Text a fully managed service that enables the exchange of SMS messages between fixed line and fixed line, fixed line and mobile and mobile and fixed line.

In March 2005 we launched a mobile managed bulk SMS, which enables customers to send and receive multiple text messages via the internet to and from their customers' mobile telephones.

Defend our traditional business vigorously

We face continued challenges in our traditional markets as a result of regulatory intervention, competition and a shift in our customers' buying patterns, as we provide them with higher-specification, high-value, new wave products.

Total fixed-to-fixed voice call minutes in the UK market as a whole declined by 3% in the 2005 financial year. This was driven by customers making use of alternatives such as mobile calls, email, instant messaging, corporate IPVPNs and VOIP.

However, the measurement of call minutes is less important to BT as customer take-up of pricing packages continues and we actively encourage the migration of customers to new wave services such as broadband.

Traditional services for consumers

On 1 July 2004, we abolished the standard rate and switched all existing standard rate customers to BT Together Option 1, offering them better value for money and making it easier for them to compare our prices with those of our competitors. We also reduced the price of Option 1 by £1 a month, offering savings to the five million customers who were already on this option.

BT Together Option 2, which offers free UK evening and weekend calls, and BT Together Option 3, which offers free UK daytime, evening and weekend calls, were also significant elements in our revenue defence strategy in the 2005 financial year.

In September 2004, we introduced CallMobile, a discount package offering customers up to 40% savings on all fixed-to-mobile calls.

During the 2005 financial year, we developed two new products to help customers protect themselves against internet dialler problems. BT Modem Protection is a free software download, which will prevent a customer's computer dialling high-cost, premium rate or international numbers. We have also developed an early warning alert in the form of a text or voice message to their mobile or fixed-line phone for customers whose bill rises significantly above the usual daily pattern. We can then put in place an immediate premium rate bar on the line and/or suggest other barring options. As at 31 March 2005, around one million BT customers had signed up for one or more of these barring services.

We manage around 87,000 public payphones, including more than 1,300 multimedia kiosks and more than 1,400 textphones throughout the UK. Although we remain committed to ensuring that public payphones are available in communities throughout the UK, future growth opportunities will focus on maximising returns from existing sites and capabilities, including e-kiosks and content services, as well as hosting CCTV (closed circuit TV) facilities and mobile antennae.

Following our re-entry into the printed classified directory market, the Phone Book continued to be successful in the 2005 financial year, with all 171 editions now including a new classified section. A new milestone will be reached in mid-June 2005, from which date all editions will include classified advertising in colour.

Traditional services for business customers

In the 2005 financial year, we made a number of enhancements to our BT Business Plan. In May 2004, in response to EU enlargement, we extended the benefits of BT Business Plan by including ten new entrant countries in the 20 pence cap on calls to Europe lasting less than one hour. In August 2004, we extended BT Business Plan to cover all business customers, irrespective of size or spend. And from September 2004, we cut the cost of fixed-to-mobile calls by 25% to 30% and offered BT Business Plan customers the chance to opt for a 30 pence cap on all fixed-to-mobile calls lasting less than one hour. At 31 March 2005, BT Business Plan had over 440,000 locations, up 67% on the 2004 financial year.

Our BT Local Business initiative helped to secure BT's position as a key player in the SME market. At the end of the 2005 financial year, BT Local Business was active in 83 locations around the country, managing £1.2 billion of annual billed turnover.

Traditional services for wholesale customers

In the 2005 financial year, despite average price reductions of 7% and growing competitive pressure in the UK market, wholesale revenues from traditional activities in the UK grew by 1% overall. We continued to invest in improvements to our processes and systems, reducing both provision and repair times.

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We continued to develop our capability as a supplier of network facilities management. For example, we are providing maintenance support to the physical field and core switching elements of O2's 3G network. As at 31 March 2005, our wholesale line rental product had over one million end users, with revenues up £51 million in the 2005 financial year.

We have also enhanced our data connectivity portfolio with the launch of a range of Ethernet (LAN) products and higher bandwidth circuits. This has enabled us to grow revenues from the provision of infrastructure to other network providers.

Product launches in the 2005 financial year included Wholesale Extension Service – a high-speed, point-to-point data circuit providing a secure link between a third party customer site and a communication provider's networks – and BT Enterprise Ethernet – a low bandwidth variant of the MegaStream Ethernet product, offering many of the characteristics of a traditional private circuit, but with the added benefit of low-cost Ethernet interface.

Drive for cost leadership

We remain focused on financial discipline and our cost efficiency programmes achieved savings of around £400 million in the year. This has enabled us to invest in growing our new wave activities. We aim to deliver at least £300 million to £400 million of savings in each of the next three years.

We aim to deliver this by focusing on the cost of failure, complexity and duplication and by working smarter. For example, at 31 March 2005 we had 6.2 million on-line relationships with customers through bt.com and almost two million customers receiving e-bills. We continue to benchmark ourselves against the best in the industry and set targets accordingly.

Keep a relentless focus on improving customer satisfaction

Reducing customer dissatisfaction by 25% a year over three years, on a compound annual basis, to the 2005 financial year was a key target in our drive to deliver the highest levels of customer satisfaction. In the 2005 financial year, for the third year in a row, all lines of business reduced customer dissatisfaction levels. This result is based on quantitative customer research conducted by independent external agencies and represents a group-wide reduction of 23% on a compound annual basis over the past three years.

The quality of service we provide to our customers is key to improving customer satisfaction. Much of our training and development activity remains focused on removing any barriers to the delivery of excellent customer service and a high-quality customer experience. Our core people engagement initiative is the *my customer* programme, which aims to enable all BT people to deliver great customer service through teamwork. Over 3,000 issues have been identified and resolved. More than 4,000 people are members of teams tasked with making further improvements as part of the 2005 *my customer* Challenge Cup.

Transform our network for the twenty-first century

Our UK network today

BT has the most comprehensive communications network in the UK, with 684 local and 135 trunk processor units, more than 121 million kilometres of copper wire and more than seven million kilometres of optical fibre, and we have the most extensive IP backbone network in the UK. The network services we provide include Frame Relay, ATM (asynchronous transfer mode) and IPVPN.

Our global reach

BT has one of the broadest IP-enabled networks in Europe and our network-based services extend to and across North and South America and the Asia Pacific region, and are delivered locally through interconnect and supply agreements with regional carriers.

As at 31 March 2005, our flagship MPLS product provided coverage and support to 72 countries from over 1,000 points of presence. MPLS revenues grew by 48% during the 2005 financial year.

Global customer service is provided via service and network management centres around the world, 24 hours a day, seven days a week.

Transforming our networks, systems and services for the twenty-first century

Our 21CN programme will lead to the simplification of BT's complex multiple networks, making it easier for us, and other operators who interconnect with BT's network, to deliver compelling converged services.

The 21CN programme has three broad goals:

to enhance the service experience, flexibility and value we provide to all our customers;

to accelerate the delivery of innovative new products and services to market; and to reduce costs radically.

Technical trials began in the 2005 financial year. For example, we launched a voice transformation trial, moving voice traffic from the traditional PSTN (public switched telecommunications network) onto an IP network.

We made significant progress towards completing the detailed technical and architectural designs to support the implementation of 21CN.

In April 2005, we announced the preferred suppliers that we expect will help to build and implement the 21CN. This was the culmination of two years of discussions and negotiations with over 300 potential technology suppliers and is one of the largest procurement programmes ever undertaken in the communications industry. The eight preferred suppliers chosen are: Alcatel, Ciena, Cisco, Ericsson, Fujitsu, Huawei, Lucent and Siemens. We expect to conclude contractual discussions with these preferred suppliers in summer 2005.

A programme of industry consultation Consult21 was launched in the 2005 financial year to promote a shared understanding with industry of the 21CN vision and the progress we are making, giving our wholesale customers an opportunity to input and influence its development.

Motivate our people and live the BT values

Our customers have a right to expect that we will understand their needs and live our brand values. This presents the 102,100 people employed by BT at 31 March 2005 with opportunities to develop innovative solutions, generate new business, drive efficiencies, and experience personal growth.

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Our vision is of high-performing, engaged and motivated people who can make a difference for customers, shareholders, the company and themselves. Only by living our values – trustworthy, helpful, straightforward, inspiring and heart – will we deliver our strategy, keep our promises to our customers, seize new opportunities in new markets and re-invent our traditional business.

Developing leaders

The quality of leadership in the company is key to the successful delivery of our strategy for transformation and growth and we have updated and refined our approach to using selection agencies for key posts, while the core leadership development programme, introduced in 2003, continues to drive our management development initiatives.

Engaging and motivating our people

Our annual employee attitude survey was conducted most recently in February 2005.

Among the key results were that 89% of our people have a clear understanding of how their work contributes to BT's success, and seven out of ten employees are willing to try new ways of doing things.

The survey generates around 5,000 feedback reports for managers and their teams across the business, helping to promote effective team working.

Employees are kept informed about our business through a wide range of communications channels, including our online news service, monthly newspaper, regular email bulletins and senior management web chats and web cast briefings.

In the UK, two main trade unions are recognised by the company. In continental Europe, we work closely with the works councils, both on an operational basis and as strategic stakeholders.

Rewarding and recognising achievement

In the 2005 financial year, we introduced a new reward framework for our managers. Salary ranges are now aligned with the going rate for equivalent jobs across a range of comparable organisations, geographies and skill sets. This ensures we remain competitive, and are able to recruit and retain the people we need.

We also continued to provide our employees with opportunities to acquire a stake in the company. Under the BT Employee Share Investment Plan (ESIP), BT can provide free shares to employees and, in addition, employees can purchase shares in the company from their pre-tax salaries. In the 2005 financial year, £11 million was allocated to provide free shares to employees under the ESIP. Employees outside the UK receive a cash payment equivalent to the value of the shares. This allocation of profits was linked to the achievement of corporate performance measures determined by the Board. In addition, employees can buy shares at a discount under our savings-related share option plans. Over 98% of eligible employees participate in one or more of these plans.

Pensions

Most of our employees are members of the BT Pension Scheme or the BT Retirement Plan, both of which are controlled by independent trustees. The BT Pension Scheme was closed to new members on 31 March 2001. The majority of new employees are eligible to join the BT Retirement Plan.

Health and safety

The health and safety of our people is of paramount importance. We have a zero tolerance of workplace accidents, and have reduced the number of reportable employee accidents from 146 cases per 10,000 employees in the 2001 financial year to 61 cases per 10,000 employees in the 2005 financial year.

In the 2005 financial year, we launched the Health and Wellbeing Forum to promote ways of working that help people balance the demands of their work and personal lives, as well as focusing on specific healthcare issues. We also developed an in-house process to help BT people manage stress.

Learning now and for the future

Our successful company-wide re-accreditation to Investors in People in February 2005, first achieved in 1998, demonstrates our continuing commitment to the effective alignment of our communications, training and development with our business strategy.

To improve the effectiveness and efficiency of our training delivery, we conducted a strategic review of our

training suppliers in the 2005 financial year, reducing them to a core group of 36. This will contribute to year-on-year savings of at least £3.4 million.

The development opportunities available to our people range from one-to-one coaching, using a combination of internal and external professional coaches, to the BT-sponsored MBA programme, which has produced 54 graduates in the past three years.

Embedding flexibility and diversity

The changing nature of the markets in which we operate, our focus on cost leadership and our investment in new services have impacted the shape of our permanent workforce.

During the 2005 financial year, 3,903 (2004 □ 2,287) people joined BT, natural attrition was running at 2.6% (2004 □ 2.4%) and, in the UK, 2,685 (2004 □ 4,814) people left BT under our voluntary paid leaver package.

We are committed to helping our people optimise their work/life balance. At the end of March 2005, for example, more than 8,900 people were working mainly from home.

We continue to create a working environment that actively supports all our employees □ regardless of gender, race, sexual orientation, disability or age.

Research and development and IT support

Through our IT division, BT Exact, we offer the services of thousands of IT professionals with knowledge of leading-edge network design and IT systems and application development, together with skills in innovation, change management and IT operations.

Over the last year, we have transformed our approach to internal and external systems development through the establishment of 90-day design, development and delivery cycles, accelerating our ability to deliver systems which support product development and all our customers to much tighter timescales and much higher levels of □right first time□ delivery. We are also developing new high-quality online ways for customers to deal with us, in an intuitive and comprehensive manner.

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The GCTO (Group Chief Technology Office) sets and drives the innovation and technology strategy for BT. GCTO includes a global technology intelligence scouting unit, teams focused on innovative new wave service opportunities, an innovation design and media team, strategic technology analysis units, a network and systems architecture team and world-class research and venturing facilities in Adastral Park (England) and Malaysia.

The work undertaken by GCTO is part of BT's £257 million investment in research and development in the 2005 financial year. This compares with £334 million and £380 million invested in the 2004 and 2003 financial years, respectively. We continue to focus our innovation work on key areas which support our business and technology strategies, filing 109 new patent applications in the 2005 financial year and maintaining a total patent portfolio of 7,400 patents and applications. Among the awards won by our technology research team was the British Computing Society's IT Developer of the Year.

BT is a limited partner in the independent corporate venturing partnership, NVP Brightstar, which generates value by launching key innovations as new high-technology businesses.

Property

At 31 March 2005, BT occupied approximately 6,600 properties, located principally in the UK. Most of this property portfolio is owned by Telereal Group, a 50/50 joint venture between Land Securities Trillium and William Pears Group.

The majority of these properties are specialised operational buildings. They mainly house exchange equipment and are needed as part of BT's continuing activities. Other, general purpose, properties consist chiefly of offices, depots and computer centres.

Our property strategy is to continue to reduce costs, at the same time as increasing usage and income generation.

In the 2005 financial year, we sublet an additional 21,000sqm of office space, vacated 158,000sqm of space ready for disposal and successfully disposed of Mondial House in London for £51 million.

Regulation, competition and prices

The commercial environment in the UK and in the countries in which BT operates is increasingly competitive and dynamic. However, we remain subject to extensive regulation, particularly in the UK, which can materially affect the way in which we carry out our business. We also use inputs, such as networks and services from other regulated operators, largely outside the UK, and the availability and price of these inputs may change from time to time, which in turn affects our business.

Regulation in the UK

It is our policy to be fully compliant with the regulatory framework in which we operate. During the 2005 financial year, we continued to strengthen our compliance activities and, in addition, we have worked closely with compliance professionals in the telecommunications and other regulated industries in the UK to establish best practice. We have been in contact with European telecommunications companies with the intention of sharing ideas and best practice and bringing improvements to the UK market. Our compliance policy remains focused on ensuring that we continue to meet the obligations imposed by, or under, the UK's Communications Act 2003 (the Communications Act) and the Competition Act 1998 (the Competition Act) while competing fairly and vigorously within the rules. We publish an annual compliance report which can be found in our social and environment report at www.bt.com/betterworld

Ofcom

The UK regulatory environment changed materially in July 2003, when the Communications Act came into force, bringing in a new regulator, the Office of Communications (Ofcom), and a new regulatory framework for electronic communications networks and services.

Ofcom was set up as a result of the increasing convergence between telecommunications, broadcasting and radio, to provide a single, seamless approach to regulation across the whole converging marketplace. It amalgamated the roles of five former regulatory agencies: the Director General of Telecommunications (OfTel), the Independent Television Commission, the Broadcasting Standards Commission, the Radio Authority and the Radiocommunications Agency.

Ofcom is headed by a board consisting of a chairman, executive and non-executive members. Currently, the chairman is Lord Currie and the chief executive is Stephen Carter.

Ofcom has a wide range of general and specific duties laid down in the Communications Act. Below is a summary of those duties and functions of particular relevance to BT's activities:

the principal duty to further the interests of citizens in relation to communications matters and, secondly, to further the interests of consumers, where appropriate, by promoting competition. In doing so, Ofcom must secure, among other things, the availability of a wide range of electronic communications services in the UK; the duty to have regard to the principles under which its regulatory activities should be transparent, accountable, proportionate, consistent and appropriately targeted;

the duty to review regulatory burdens on a regular basis and ensure that they do not involve the imposition or maintenance of unnecessary burdens; and

the functions of setting conditions of entitlement (see **Regulatory conditions**), and enforcing those conditions (see **Enforcement**). Ofcom's decisions are subject to appeal on the merits (see **Appeals**).

In carrying out its duties, Ofcom must consider promoting competition and the use of effective self-regulation, encouraging investment and innovation, and encouraging the availability and use of high-speed data services (including broadband).

[Regulatory conditions](#)

Under the new framework, based on 2003 EU Directives, providers may no longer be required to obtain licences before offering telecommunications services. Individual licences, such as that granted to BT in 1984, no longer exist. Instead, there is a general authorisation for the provision of electronic communications networks and services.

Regulation is applied through separate sets of conditions made by Ofcom, of which some apply to all relevant communications providers. Others are imposed

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individually on particular providers which, following a review of the relevant markets, are found to have "Significant Market Power" (SMP) or are designated as "Universal Service Providers". Other general obligations are set out in the Communications Act. The general and specific obligations that form BT's regulatory environment are described below.

Conditions applying to all providers of electronic communications networks or services

General conditions

The foundation of the new regulatory framework is the set of general obligations referred to in the Communications Act as "General Conditions". These apply to all providers of electronic communications networks or services, including "systemless" service providers and internet service providers. These conditions are mainly concerned with consumer protection, but also address matters such as general access and interconnection obligations, standards, emergency planning and numbering. In addition, a separate condition has been set regulating the provision of premium rate services.

Electronic Communications Code conditions

The Electronic Communications Code deals with powers to carry out streetworks and similar activities for the purposes of providing networks and its application is subject to conditions made by the Secretary of State for Trade and Industry.

Other general obligations

Other obligations corresponding to former licence conditions under the old framework now apply directly through provisions of the Communications Act. These are:

- the payment of administrative charges (broadly the equivalent of licence fees under the old framework); and
- the provision of information to Ofcom when required to do so.

Conditions applying to BT only

Universal Service Obligation conditions

BT has been designated as the supplier of Universal Service for the UK excluding the Hull area, where Kingston Communications is the designated provider. The services covered by the Universal Service Obligation (USO) are defined in an Order issued by the Secretary of State for Trade and Industry. Our basic obligation is to provide a single narrowband connection to the fixed telephone network, but additional USO conditions relate to issues such as schemes for consumers with special social needs and the provision of payphone services.

Ofcom is currently reviewing the USO. The review is focused on delivering the current Universal Service arrangements and is being carried out alongside Ofcom's Strategic Review of Telecommunications (see **Other significant changes and issues** - **Strategic Review of Telecommunications**) which looks at longer-term Universal Service issues.

Significant Market Power conditions

The Communications Act, implementing the EU Directives on which the regulatory framework is based, requires Ofcom to define and analyse markets ("market review") and to determine whether any communications provider has SMP, which is aligned with the competition law concept of dominance. Economic regulation can only be imposed following a market review and finding of SMP.

In markets where Ofcom finds that a provider has SMP, it must impose appropriate additional obligations in the form of SMP conditions as specified in the Communications Act. These may include obligations to meet reasonable requests to supply certain services to other communications providers, not to unduly discriminate, and to notify price changes. In some cases, additional obligations relating to, for example, price control and regulatory accounting have also been imposed.

The market reviews relevant to fixed telecommunications that Oftel and Ofcom have conducted are listed below. For each review, the markets in which BT has been determined to have SMP are shown. All references to UK markets, except wholesale trunk segments and broadband conveyance, exclude the Hull area.

Fixed narrowband retail markets in the UK:

- residential analogue lines, residential ISDN2 lines, business analogue lines, business ISDN2 lines, ISDN 30 lines, residential local calls, residential national calls, residential calls to mobile, residential operator assistance calls, residential international direct-dialled calls, business local calls, business national calls, business calls to mobile, business operator assistance calls.

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Fixed narrowband wholesale markets in the UK:

residential analogue lines, residential ISDN2 lines, business analogue lines, business ISDN2 lines, ISDN 30 lines, call origination, local-tandem conveyance and transit, inter-tandem conveyance and transit, single transit.

Fixed geographic call termination markets in the UK:

fixed geographic call termination provided by BT and other members of the BT group of companies.

Wholesale international services markets:

wholesale international services on 108 country routes.

Wholesale unmetered narrowband internet termination markets:

BT was not found to have SMP in any market considered in this market review.

Retail leased lines, symmetric broadband origination and trunk segments markets:

retail traditional interface leased lines at speeds up to and including 8Mbit/s; wholesale traditional interface

symmetric broadband origination at speeds up to and including 8Mbit/s; wholesale traditional interface

symmetric broadband origination at speeds above 8Mbit/s and up to and including 155Mbit/s; wholesale

alternative interface symmetric broadband origination at all bandwidths. Wholesale trunk segments at all bandwidths.

Wholesale broadband access markets in the UK:

asymmetric broadband origination; broadband conveyance.

Wholesale local access markets in the UK:

wholesale local access services.

The Communications Act allows Ofcom to review markets for end-user apparatus and impose conditions on any provider designated with SMP. The conditions which may be imposed are limited to conditions relating to accounting separation, cost accounting, and price control for hardwired telephone rental charges. Ofcom has decided that BT's price controls in respect of rental of hardwired telephone

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apparatus, brought forward from the old regulatory regime, should be removed and replaced by written undertakings rather than by SMP apparatus conditions.

The Act obliges Ofcom to carry out further analyses of markets which have been reviewed at such intervals as it considers appropriate. In the Phase 2 consultation document in the Strategic Review of Telecommunications, Ofcom has made proposals for a number of market reviews over the coming years. Ofcom is currently carrying out a review of the Number Translation Services (NTS) Call Termination market.

Enforcement

The Communications Act sets out the enforcement process to be followed in relation to breaches of conditions. Where a breach is not remedied following preliminary notification by Ofcom, Ofcom may take legally enforceable enforcement action and/or impose a penalty of up to 10% of relevant turnover. In addition, a person who suffers loss or damage as a result of a breach may, with Ofcom's consent, sue for damages, and, in the case of serious and repeated contraventions, Ofcom may restrict or suspend the provider's entitlement to provide electronic communications networks or services.

The Communications Act contains similar enforcement procedures (though with much smaller penalties) for matters such as non-compliance with a request for information or non-payment of an administrative charge.

Appeals

One of the main features of the new regulatory framework is that full appeals on the merits are now available against regulatory decisions. Consequently, appeals can be made against matters such as:

- the making of SMP, SMP apparatus and USO determinations/designations;
- the setting, modification and revocation of conditions;
- enforcement actions, including the imposition of a penalty.

Any person affected by a decision may appeal to the Competition Appeals Tribunal. However, the Tribunal must refer any matters in any appeal relating to price controls on to the Competition Commission for determination.

In November 2003, Ofcom issued a notification finding that BT was acting in contravention of the General Conditions by using customer-specific information acquired from other communications providers in connection with the provision of Carrier Pre-Selection (CPS). In May 2004, Ofcom issued a second notification finding that BT was similarly contravening the General Conditions in relation to Wholesale Line Rental (WLR). BT appealed both notifications, and the Tribunal adjourned the WLR appeal pending the outcome of the CPS appeal.

In December 2004, the Tribunal dismissed BT's CPS appeal and upheld that notification (although this was subject to a clarification of the definition of "marketing activity" as set out in the notification). Subsequently, Ofcom withdrew the contested WLR notification, indicating that it would issue a new notification in light of the CPS decision. The Tribunal has suspended the WLR appeal pending the new notification, which is expected shortly.

Competition

The competitive environment

The UK telecommunications market is fully open and highly competitive.

Although it is some years since the Telecommunications Act 1984 abolished the monopoly of the former statutory corporation, British Telecommunications, obligations placed on BT, including pricing regulation, network access, non-discrimination, the provision of universal service and cost accounting/accounting separation, are generally more onerous than for other providers of electronic communications networks and services.

Competition and the UK economy

The growth of mobile over the past decade has been a major factor in shaping the UK's telecommunications landscape. Mobile now accounts for approximately 30% of total UK voice minutes. BT's market share of the total UK voice market, including mobile, is estimated to have fallen by about 4% in the 2005 financial year to approximately 40%.

BT's share of the residential fixed-voice market, as measured by the volume of fixed-to-fixed voice minutes, declined to an estimated 64% for the 2005 financial year, compared with an estimated 70% and 74% for the 2004 and 2003 financial years, respectively. CPS has been one of the contributors to the loss of share in the fixed-voice market. We estimate that BT had 42% of the market for business fixed-voice calls in the 2005 financial year, compared with an estimated 44% and 47% in the 2004 and 2003 financial years, respectively.

Estimated market shares are based on our actual minutes, market data provided by Ofcom and an

extrapolation of the historical market trends.

We also estimate that BT supplied approximately 79% of exchange lines in the UK at the end of the 2005 financial year, compared with 82% and 83% in the 2004 and 2003 financial years, respectively.

The growth in cable operators' networks in the UK has historically had an adverse effect on BT's share of the residential market. Current and future wholesale line rental arrangements will allow BT's fixed-line customers to move PSTN lines to other operators which are expected to be the source of more competition in the future.

Since 2000, we have been required to provide other operators with the use of the lines connecting BT's local exchanges to our customers and to other operators to install equipment in our exchanges (see **Local Loop Unbundling**).

Competition Law

In addition to telecommunications industry regulation, BT is subject to general competition law including the Competition Act in the UK and the competition law provisions of the EC Treaty.

UK and European Union competition law both prohibit anti-competitive agreements, concerted practices and the abuse of a dominant market position. In the application of UK and EU competition law to electronic communications, Ofcom has concurrent investigatory and enforcement powers with the Office of Fair Trading (OFT). The EC has jurisdiction to apply the EU rules. Breach of the relevant prohibitions in the UK or EU rules could lead to fines of up to 10% of worldwide turnover in a company's previous financial year and/or result in claims for damages in

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national courts. A company may also be ordered to cease an infringing activity. There is an independent mechanism for appeals to the Competition Appeal Tribunal against decisions taken by Ofcom or the OFT and to the European Court of First Instance against EC decisions.

In July 2005, the Tribunal is due to hear Wanadoo's appeal against Ofcom's November 2003 finding that BT had not infringed the prohibition on abuse of a dominant position in relation to the pricing of BT Openworld's consumer broadband products. Separately, in August 2004, Ofcom claimed that BT had abused a dominant position in relation to its pricing of consumer broadband products. BT has responded, arguing that its pricing does not amount to an abuse of dominance. Ofcom has indicated that it will issue either a new statement of objections or a decision of non-infringement in relation to this case, in June 2005.

Enterprise Act

The Enterprise Act 2002 aims to give more independence to the competition authorities, to reform insolvency and bankruptcy laws and to tackle trading practices that harm consumers.

The key provisions of the Enterprise Act, including the new cartel offence and the section on director disqualification, entered into force on 20 June 2003. It is now a criminal offence, punishable by imprisonment or a fine, or both, to engage in cartel activity. In addition, where companies infringe UK or EU competition law, company directors can be disqualified from being concerned in the management of a company for a maximum period of 15 years. The Enterprise Act also gives the OFT power to make a market investigation reference to the UK's Competition Commission where the OFT has reasonable grounds for suspecting that any feature of a market prevents, restricts or distorts competition in the supply or acquisition of goods or services in the UK. Once the OFT exercises its power to make such a reference, the Competition Commission is required to decide whether any feature of the market prevents, restricts or distorts competition ("adverse effect") and, if so, to take action to remedy the adverse effects. Market investigations are intended to address competition issues in markets as a whole and not merely the behaviour of individual players. In relation to electronic communications markets, Ofcom has concurrent powers with the OFT to make a market investigation reference.

Pricing regulation

Fixed network

We are subject to price controls on our fixed network services in the UK at two levels: retail and network. Fixed network competitors are generally not subject to direct price controls, although there are some controls on mobile network operators.

Retail price controls

We are subject to two sets of UK retail price controls, one on certain public-switched telephony call charges and exchange line rentals, and one on certain private circuits. Each price control is based on a formula calculated by reference to the UK Retail Prices Index (RPI) and a factor, X.

For services covered by the controls, the weighted average of base prices cannot increase in each year beginning 1 August by more than the annual change in RPI minus X. The current retail price control for public-switched telephony, applying from August 2002 to July 2006, is RPI minus RPI (ie the value of X is RPI and prices cannot increase). It is measured on services used by the lowest 80% of our residential customers classified by bill size. From August 2002, the services covered by the control were extended to include BT's share of the revenue for calls to all four mobile networks, replacing the previous separate control on BT for calls to Vodafone and O2. The price control formula and our performance against the formula are set out in the table below.

Under the price controls for private circuits that applied from August 1997 to July 2001, prices for domestic analogue and low-speed digital private circuits could not increase by more than the change in the RPI in any year. For all retail analogue private circuits and 8Mbit/s digital private circuits, BT has also given an assurance to adhere to a RPI+0% price cap from 30 June 2003 until 30 June 2006.

As part of the review of price controls in 2002, BT was required to provide a cost-based wholesale line rental product to other service providers at a regulated price and in a way that does not unduly discriminate between BT's retail business and service providers. This product, Wholesale Access, has been available from BT since 1 September 2002. Further consultation by Ofcom resulted in an enhanced wholesale access product being available from 29 March 2004. When Ofcom notifies BT that it is satisfied in relation to the introduction and provision of Wholesale Access, it may direct that the retail price control be adjusted to RPI+0%.

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Price Control (RPI-X)	Years commencing 1 August				
	2000	2001	2002	2003	2004
% RPI movement for the relevant period ^a	3.32	1.93	1.03	2.89	3.03
X on price control formula ^{a,b}	4.50	4.50	1.03	2.89	3.03
% required change in base prices ^{c,d}	(1.09)	(2.45)	0	0	0
% change in base prices overall	(1.20)	(2.50)	(0.22)	(0.19)	0.46 ^e

^a Annual increase in RPI to previous June

^b From 1 August 1997, the RPI formula covers the main switched telephone services provided to the lowest 80% of BT's residential customers by bill size

^c After permitted carry forward of any unused allowance or shortfall from previous years

^d From 1 August 2002, the RPI formula covers the change in average prices (including residential discount packages)

^e Full year forecast based on price changes implemented up to January 2005 for residential customers. There is an unused allowance of 0.41% carried forward from the previous year which would allow prices to rise by this amount in 2005. Further price changes during this year could eliminate the current variance but if not, the amount may be carried forward.

Table of ContentsNetwork Charge Control

We operate under interconnection agreements with most other operators. Our charges for a range of interconnect services are controlled by Ofcom, under the Network Charge Control (NCC) regime. The current NCC period began on 1 October 2001 and will last until 30 September 2005. The controls are designed to ensure that our charges are reasonably derived from costs, plus an appropriate return on capital employed. Depending on the degree of competition for these services, charges are cap-controlled each year by RPI minus X (where X ranges from 7.5% to 13%) for services Ofcom considers unlikely to become competitive in the near future and safeguard cap-controlled (ie no increases above RPI during any relevant year of the overall control period) for services likely to become competitive. Those services considered fully competitive are not subject to direct charge controls.

The main network price caps are listed below:

Basket	X Factor in RPI - X formula	Duration
Call termination	10	30 Sept 2005
Call origination	10	30 Sept 2005
Tandem layer	13	30 Sept 2005
Safeguard cap	0	30 Sept 2005
Interconnect specific	8.25	30 Sept 2005
Local exchange FRIACO	7.5	30 Sept 2005

BT must publish a notification to Ofcom and other operators if we intend to amend existing charges or to offer new services. Notice periods range from 28 to 90 days for regulated services, depending on the degree to which they are judged to be competitive.

In 2004, Ofcom began a review of the NCC, to determine the controls to apply from 1 October 2005. On 23 March 2005, Ofcom issued a consultation document ("Review of BT's Network Charge Controls") proposing a further four-year NCC regime, with a review of BT's market power in two specific markets (deregulation being proposed for one of these markets). Ofcom is also proposing some re-definitions of basket services, and consulting on a range of values of X for these services (reflecting the fact that some of the relevant factors in setting X are yet to be resolved). We will respond to Ofcom's proposals by 1 June; Ofcom is expected to publish a statement by the end of July 2005.

The various services and proposed ranges of X within Ofcom's 23 March consultation document are listed below:

Basket	X Factor in RPI - X formula
Call termination	2.25 to 6.25
Call origination	0.5 to 4.5
Single transit	11 to 14
Local-tandem conveyance	0 (safeguard)
Interconnection circuits	1.5 to 5.5
Product management, policy and planning	2.5 to 6.5
Local exchange FRIACO	7.5 to 11.25
Single tandem FRIACO	8.5 to 12.25
Inter-tandem conveyance / transit	No control (propose to de-regulate)

Number portability

The number portability charge control runs from 1 August 2002 until 31 July 2006. The charges are controlled by a RPI minus X formula, with X set at 5%. This control is not contained in an SMP condition, but in a non-binding undertaking given by BT to Ofcom. Under the new regime, General Condition 18 requires all providers to offer number portability, among other things, on reasonable terms and for charges to be cost-orientated.

Wholesale access charge control

The charges for wholesale access services (both analogue and digital) are also subject to price control. The charges for the line rental (residential and business products), line transfer and new line installations have been set by Ofcom and are subject to a price control of RPI minus 2%, effective from 1 September 2002 for four years. The control applies to the aggregate of all charges (rental, transfer and installation) as well as to line transfers separately. We are also under an obligation to notify Ofcom and service providers if we intend to amend existing charges or introduce new charges. Notice periods range from 28 to 90 days, depending on the specific service.

On 28 November 2003, Oftel published its statement on the fixed narrowband wholesale exchange line market. This statement contained new obligations on BT to provide Wholesale Business ISDN2 Line Rental with cost-oriented prices and to provide residential ISDN2 and ISDN30. We launched the required products but the price level was referred to Ofcom as a dispute by Energis on 25 October 2004. On 2 February 2005, Ofcom determined that BT's price was set at too high a level and that BT must refund Energis an amount for each line rented during the period from 23 November 2003 to 30 September 2004.

Additionally, during the year a small-scale consultation was carried out which aligned the price control formulae for Wholesale Access, NCC and PPC (Partial Private Circuits) but this did not affect the Wholesale Access control in a material way.

Partial Private Circuit Charge Control

PPCs are leased lines that BT sells to other network operators. On 1 October 2004, Ofcom introduced a PPC charge control to replace the annual determinations previously carried out by Oftel. The control arises from regulation established in the Leased Lines Market Review (LLMR) and deals with PPC terminating segments (the "access" part of the leased line network).

The control is a four year RPI-X type control with three separate baskets:

Low Bandwidth Basket (RPI-4%);

High Bandwidth Basket (RPI-6.5%); and

Equipment Basket (RPI-8.9%).

Charges prior to the control were maintained as starting charges and BT is required to make price reductions each year which comply with the controls. However, control formulae are constructed to allow BT some discretion in the timing of the price changes and the ability to meet the control by re-balancing different elements of the PPC charges.

PPCs are also subject to obligations to notify operators and Ofcom if we intend to revise charges or other contractual conditions. The notification periods range

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from same day to 90 calendar days depending on the nature of the change.

Non-UK regulation

BT must comply with the regulatory regimes in the countries in which we operate or wish to operate. The obligations placed on us and our suppliers continue to be relevant to our business models and have cost implications for our end-user services. These rules are generally applied by national regulatory authorities operating under a government mandate. The decisions of these bodies can have a material impact on our business models from time to time.

European Union

The degree to which the European Directives have been implemented varies by country. The general move towards the new regime continues in the original EU15 member states before enlargement, although in some of these countries, the implementation of the directives is progressing slowly. In most, but not all, of these EU15 member states, the primary legislation that will enable the introduction of the new regulatory regime is going through, or has been through, the legislative process. The processes of identification of operators with SMP and the subsequent setting of regulatory obligations on those operators are mostly in progress. The EU10 accession member states are in the early stages of implementing these directives.

BT will not have universal service obligations outside the UK, although in certain member states we may be required to contribute towards an industry fund to pay for the cost of meeting universal service obligations in those countries. Any findings that BT has SMP in any non-UK market are not expected to have a material impact. We are lobbying the European Commission and other EU bodies with responsibility for electronic communications for consistent and timely implementation of the new directives and associated regulation.

The availability of cost-oriented access products from regulated incumbents remains an important element of our strategy around the world and we continue to press these incumbents, their national regulatory authorities and at the EU level for such access. Availability varies by country.

The European Commission is formally investigating the way the UK Government has set BT's property rates and those paid by Kingston Communications. The Commission is examining whether the Government has complied with EC Treaty rules on state aid in assessing BT's rates. BT's rates were set by the Valuation Office after lengthy discussions based on well established principles in a transparent process. In BT's view, any allegation of state aid is groundless and BT is confident that the Government will demonstrate the fairness of the UK ratings system. A finding against the UK Government could result in BT having to repay any state aid it may be determined to have received.

Rest of the world

The vast majority of the markets in which we operate around the world are regulated, and in the majority of these we have to obtain licences or other authorisations and comply with applicable conditions. The degree to which these markets are liberalised varies widely: while many are fully open to competition, others place restrictions on market entrants, such as the extent to which foreign ownership is permitted, or restrictions on the services which may be provided. The extent to which the national incumbent operator is effectively regulated also varies considerably. BT's ability to compete fully in some countries is therefore constrained.

Other significant changes and issues

Strategic Review of Telecommunications

Ofcom is carrying out a Strategic Review of the UK telecommunications sector (the "Strategic Review"). The first consultation document was published in April 2004 and the second in November 2004. The Strategic Review is comprehensive and wide ranging. It aims to assess the options for enhancing value and choice in the UK telecommunications sector while having regard to investment and innovation.

The first consultation document focused on five fundamental issues: the key attributes of a well-functioning telecoms market for citizen-consumers; the achievement of sustainable competition; the possibility of a significant reduction in regulation; incentivising efficient and timely investment in next-generation networks; and the relevance of the issue of structural or operational separation of BT.

The second consultation set out three options for the outcome of the Strategic Review. These were as follows:
Option 1 - full deregulation, with reliance on competition law to address competition concerns;

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Option 2 – a market investigation reference to the Competition Commission under the Enterprise Act to determine whether any feature of the market prevents or distorts competition in the supply of communications services. One possible result of such an investigation could be enforced separation of BT; and
Option 3 – delivery by BT to its competitors of “real equality of access” to its networks, with the onus on BT to bring forward prompt and clear proposals.

Option 3, which was supported by most of the respondents to Ofcom’s Phase 2 consultation, would entail introducing more effective regulation focused on enduring economic bottlenecks. Ofcom also proposed that when BT had delivered equality of access in these areas, it would withdraw many additional layers of regulation from wholesale and retail markets. In our response to the Phase 2 consultation, BT put forward proposals for a package of measures which could form the basis for a new regulatory settlement. Under these proposals, we would:

- make significant organisational changes that demonstrated our commitment to transparency and exemplary governance, including the creation within BT of a new Access Services Division based on the assets and people associated with the access network, from the customer’s premises to the main distribution frame in the local exchange;
- create an Equality of Access Board to monitor the performance of the Access Services Division and to oversee delivery of equality of access by BT;
- introduce equality of access in a phased and effective manner;
- ensure that BT’s Wholesale Access product is demonstrably fit for purpose with effective operational performance and an increased margin enabling rapid consumer take-up;

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keep Local Loop Unbundling (LLU) at the heart of BT's wholesale broadband portfolio, building on the work already done on industrialising LLU operations and taking forward our previous commitment to cut the price of fully unbundled loops;

make sure the rest of BT's broadband products keep pace so that all service providers have a wide choice of offerings to suit their business models;

agree on the enduring economic bottlenecks (assets that are not replicable in the medium term) and work to ensure that regulation is focused around them; and

set out the ground rules that underpin the development of BT's 21st Century Network.

Equally, as part of this package, BT would need Ofcom to:

- commit to rapid, significant and ongoing deregulation in certain key markets;
- create a stable investment environment, with the Strategic Review and the associated studies concluded successfully, so that investors are able to invest with certainty; and
- enable BT to compete on a level playing field with other operators in the market.

Cost of copper

Ofcom issued two consultation documents, in late 2004 and early 2005, concerning the valuation of the local access network assets, with the intention of issuing a statement in summer 2005. The review considered the valuation of the copper local access circuits and the duct through which these circuits pass. Ofcom considers the local access network to be a "bottleneck" (meaning that other fixed line telecommunications operators wishing to serve the majority of UK customers need to use BT's local access network to do so), and wishes to ensure customers continue to be charged fair prices for the use of these assets. The regulator considered alternative ways of valuing these assets, and Ofcom anticipated that it would conclude that the assets should be revalued at a lower level. Such an outcome would result in lower wholesale charges for the use of local access network assets.

Cost of capital

During its review of the PPC price control, Ofcom concluded that it should amend the allowed rate of return it should use, based on an updated calculation of BT's overall cost of capital. The September 2004 statement used an allowed rate of return of 13.0% (on a pre-tax, nominal basis), specifically for PPC prices, compared with the 13.5% rate that the regulator had previously allowed in other price controls. In January 2005, Ofcom issued a consultation document that examined various aspects of risk and reward, including aspects of the allowed return that should be used by Ofcom in setting regulated prices. The consultation proposed to review the calculation of BT's overall cost of capital, and also considered whether to allow different rates of return for different parts of BT. The regulator proposed to reduce BT's overall cost of capital, from the general current rate of 13.5%, and also suggested that the local access network was less risky than the rest of BT, and BT should therefore be allowed a lower rate of return in regulated prices. Such an outcome would result in lower wholesale charges for local access network services.

Radio base station backhaul circuits and wholesale extension services

During the 2005 financial year, we also launched two new products in line with regulations contained in the Leased Lines Market Review:

RBS (radio base station backhaul circuits) – these are circuits provided by BT to enable a mobile communications provider to connect a radio base station to its mobile switching centre; and

WES (wholesale extension services) – these are circuits provided over fibre, typically using Ethernet technology, to enable a telecoms operator to connect a customer site to its own switching site.

Neither product is currently part of a price control but Ofcom has imposed various regulatory conditions on the products, including notification and cost orientation obligations.

Local Loop Unbundling

Local Loop Unbundling (LLU) enables operators to connect directly to the consumer via BT's copper local loops and then add their own equipment to offer broadband and other services. There are two types of unbundled line:

a fully unbundled line gives operators the exclusive use of the copper line; and

a shared access line only gives operators the use of the high-frequency channel used for broadband and will also be used by the customer's fixed-line voice provider.

During the 2005 financial year, Ofcom extensively reviewed LLU regulation as it believed that development of the LLU market, allowing operators to target infrastructure investment and develop scale in the creation of high-speed data services, would be critical in ensuring a fully competitive and innovative telecoms market for the long term. However, while LLU does offer the potential for downstream service and price competition in broadband, it also requires substantial facilities and network investment by competitors.

Ofcom's latest approach to regulating LLU focused on process and price:

in July 2004 Ofcom appointed the independent Telecoms Adjudicator to handle process issues; and Ofcom completed its review of LLU prices in December 2004 as part of the wholesale local access market review.

On 16 December 2004, Ofcom announced final charges for most connection and rental prices for LLU services. The charge reductions follow consultations published on 13 May 2004 and 26 August 2004, and the price ceilings came into effect from 1 January 2005. Ofcom has published a full list of price ceilings at:

www.ofcom.org.uk/media/news/2004/12/nr_20041216

[Funds for liabilities](#)

Under conditions relating to the Electronic Communications Code, an electronic communications provider with apparatus on or in the public highway is required to make financial provision to cover any damage suffered by highway or other relevant authorities, resulting from works carried out by the communications provider, and for the removal of its network, if necessary, in the event of the liquidation or bankruptcy of the company.

The conditions require the company to provide Ofcom annually with a certificate that, in the company board's

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opinion, the company has fulfilled its obligations to ensure the availability of the required funds. This has been done by BT.

Relationship with HM Government

The UK Government, collectively, is our largest customer, but the provision of services to any one department or agency of the UK Government does not comprise a material proportion of our revenues. Except as described below, the commercial relationship between BT as a supplier and the UK Government as customer has been on a normal customer and supplier basis.

We can, however, be required by law to do certain things and provide certain services for the UK Government. General conditions made under the Communications Act 2003 require all providers of public telephone networks and/or publicly available telephone services, including BT, on the request of and in consultation with the authorities, to make, and if necessary implement, plans for the provision or restoration of services in connection with disasters. Furthermore, the Civil Contingencies Act 2004, contains provisions enabling obligations to be imposed on providers of public electronic communications networks, including BT, in connection with civil contingency planning. In addition, the Secretary of State has statutory powers to require us to take certain actions in the interests of national security and international relations.

Legal proceedings

The company does not believe that there are any pending legal proceedings which would have a material adverse effect on the financial position or operations of the group.

Proceedings have been initiated in Italy against 21 defendants, including a former BT employee, in connection with the Italian UMTS auction. Blu, in which BT held a minority interest, participated in that auction process. The hearings are continuing in Rome. If the proceedings are successful, BT could be held liable, with others, for any damages. The company has concluded that it would not be appropriate to make a provision in respect of any such potential claim.