

# Financial review

## Introduction

BT's earnings of 26.7 pence per share for the year ended 31 March 1998 (the 1998 financial year) compare with 32.8 pence for the 1997 financial year and 31.6 pence for the 1996 financial year. Earnings per share for the 1998 financial year were affected by two exceptional items. The first was a receipt of US \$465 million from WorldCom, Inc as a result of the termination of the proposed BT/MCI Communications Corporation merger; the second was the one-off windfall tax charge which amounted to £510 million.

Earnings per share for the 1998 financial year before the two exceptional items were 31.7 pence, a decrease of 3.2% on the previous year, reflecting a number of factors. In the 1998 financial year, earnings were affected by initial expenditure incurred by the group's new European associates as they become established; a charge of £120 million was incurred as compensation to employee share option holders for the special dividend paid in September 1997 and an additional charge for interest of approximately £100 million was incurred from the payment of this special dividend; BT was also affected by its £63 million share of a special charge made by MCI in September 1997.

	1998 £m	1997 £m	1996 £m
<b>Turnover</b>	<b>15,640</b>	14,935	14,446
Other operating income	<b>372</b>	106	103
Operating costs before redundancy costs	<b>(12,249)</b>	(11,429)	(11,028)
Redundancy costs	<b>(106)</b>	(367)	(421)
Operating profit	<b>3,657</b>	3,245	3,100
Group's share of profits (losses) of associated undertakings	<b>(252)</b>	139	82
Profit on sale of group undertakings	<b>63</b>	8	7
Net interest and premium payable	<b>(249)</b>	(189)	(170)
<b>Profit before taxation</b>	<b>3,219</b>	3,203	3,019
Taxation – ordinary	<b>(978)</b>	(1,102)	(1,027)
– windfall	<b>(510)</b>	–	–
<b>Profit after taxation</b>	<b>1,731</b>	2,101	1,992
Minority interests	<b>(25)</b>	(24)	(6)
Profit for the financial year	<b>1,706</b>	2,077	1,986
<b>Earnings per share</b>	<b>26.7p</b>	32.8p	31.6p
<b>Earnings per share before exceptional items</b>	<b>31.7p</b>	32.8p	31.6p

The results for the 1998 financial year have benefited from the strong growth in demand for the group's products and services and the buoyant UK economy. BT, however, continued to be affected by the tight regulatory regime in the UK and growing competition. Price reductions, including those imposed by the price control formulae, totalled over £750 million following reductions of over £800 million in the 1997 financial year and £480 million in the 1996 financial year. The 1998 financial year also included lower redundancy costs as a consequence of the surplus disclosed by the latest actuarial valuation of the group's main pension scheme.

The 1998 financial year saw the group increasing its level of investment in continental Europe to address the opportunities presented by the full liberalisation of the telecommunications market from 1 January 1998. Other features of the year included the break-up of the proposed BT/MCI merger, the payment of a £2.2 billion special dividend and the UK Government's imposition of a windfall tax on BT and other privatised companies.

The results for the 1997 financial year were adversely affected by significant redundancy costs of £367 million and a £60 million premium paid on repurchase of bonds. The 1996 financial year's results were also affected by significant redundancy costs of £421 million and a £73 million share of another MCI special charge.

## Regulation and prices

The period to 31 July 1997 was the last in which the majority of BT's main UK services were subject to price regulation. Under the price controls which were in force up to that date, BT had to reduce its overall prices for its main UK services, principally inland and outgoing international call services and exchange line rentals, under the RPI minus 7.5 formula. In the two final price control years under this formula, BT reduced its prices by about 5% and 2% in the years to 31 July 1997 and 1996, respectively.

From 1 August 1997, a new retail price control came into force under which a cap of RPI minus 4.5 applies to the services used by the lowest 80% of BT's residential customers by bill size. This new retail price control is estimated to have covered services representing about 17% of the group's total turnover for the year to 31 March 1998. In the current price control year to 31 July 1998, BT has already reduced its prices by more than the required reduction of 1.56%.

From 1 October 1997, the basis of determining most interconnect charges with other UK operators has been moved from fully allocated historical costs to long-run incremental costs. Annual determinations have been replaced with a system based on RPI minus price caps. There has been an initial reduction in charges of 10% followed by annual reductions over a four-year period based on a RPI minus 8 price cap.

The regulatory environment in the UK has had, and will continue to have, a significant adverse impact on the group's turnover and operating profit. As the group extends its operations to other countries, BT has to consider the regulatory regimes in those countries. Generally, most countries have regulatory regimes that are currently less liberal than those in the UK and North America.

**Competition and the UK economy**

BT has a significant market share in its main UK markets for telephone calls and provision of exchange lines. Competition has eroded BT's market share significantly in key market sectors, in particular areas of the UK and for certain products and services. Figures published by Oftel showed that BT had 77% of the market for national calls for the six months ended 30 September 1997, compared with 79% and 81% in the 1997 and 1996 financial years, respectively, and supplied 89% of the exchange lines in the UK at 30 September 1997, compared with 90% and 93% at 31 March 1997 and 1996, respectively. Additionally, BT had 87% of the market for local calls for the six months ended 30 September 1997, compared with 90% and 92% in the 1997 and 1996 financial years, respectively, and 52% of the market for outgoing international calls from the UK for the six months ended 30 September 1997, compared with 61% and 70% in the 1997 and 1996 financial years, respectively.

The growth in networks of cable operators in the UK is having an adverse effect on BT's share of the residential market. In the last three financial years, BT has experienced a small net reduction in residential exchange line connections as a result of increasing competition in certain geographic areas from these cable operators. This reduction is expected to continue as they build out their networks.

In an environment of strong competition, Cellnet had 34% of the market at 31 March 1998, compared with 38% at 31 March 1997 and 41% at 31 March 1996. There has also been a downward pressure on prices. Oftel has referred BT, Cellnet and Vodafone, its direct competitor, to the

Monopolies and Mergers Commission (MMC) for investigation into the charges for calls made from BT's fixed network to Cellnet and Vodafone's networks. The MMC is expected to report in autumn 1998. The company believes that the impact of the investigation is not likely to be significant to the group's financial position in view of the continuing reductions in prices.

The group has seen some diversion of demand from its fixed network as a result of the growth of other licenced operators' activities.

For its operations as a whole, BT expects the competitive pressure to persist and it will continue to defend its market share vigorously and fairly.

The strength of the UK economy is an important determinant of BT's business volumes and the gross domestic product grew by 2.9% in the year ended 31 March 1998, compared with 3.0% and 2.0% in the previous two years.

**Turnover**

Total turnover grew by 4.7% to £15,640 million in the 1998 financial year after growing by 3.4% in the 1997 financial year compared with the 1996 financial year. The strong growth in demand for the group's products and services of approximately 10% in the 1998 financial year and approximately 8% in the 1997 financial year was partially offset by the effect of price reductions which averaged approximately 5% across the business in each of the two years.

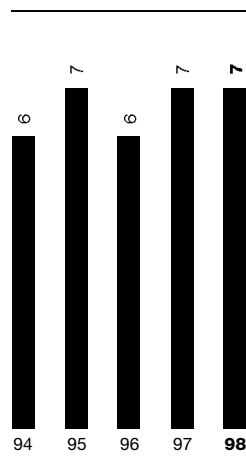
The group's turnover is analysed as follows:

	<b>1998</b>	1997	1996
	<b>£m</b>	£m	£m
Inland calls	<b>4,924</b>	4,874	4,882
International calls	<b>1,553</b>	1,809	1,980
Exchange line rentals	<b>2,957</b>	2,811	2,685
Private circuits	<b>1,149</b>	1,124	1,056
Mobile communications	<b>1,089</b>	949	856
Customer premises equipment supply	<b>896</b>	914	946
Yellow Pages and other directories	<b>466</b>	438	408
Other sales and services	<b>2,606</b>	2,016	1,633
<b>Total turnover</b>	<b>15,640</b>	14,935	14,446

Price reductions had a major impact on turnover from inland calls made over the fixed network for the fourth year in succession. Innovative marketing programmes included

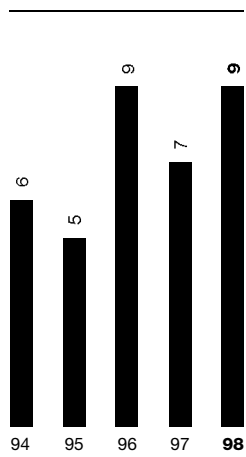
enhancements to the successful Friends & Family package, business discounts and reductions in national and fixed network to mobile call prices. The combined effect of these price changes totalled over £300 million, which was equivalent to a 6% reduction in call prices following falls of 7% in each of the previous two years.

**% annual inland call volume growth**



In the 1998 financial year, inland call volume growth of 7% was largely offset by the price reduction effect, resulting in total call turnover increasing by 1% in the year to £4,924 million. Fixed network to mobile calls and inbound services, including 0800 numbers, were the main areas of this strong volume growth, together with local and national calls. In the 1997 financial year, call volume growth of 7% almost wholly mitigated the price reduction effect, resulting in total call turnover remaining static compared with the previous year.

**% annual international call volume growth**

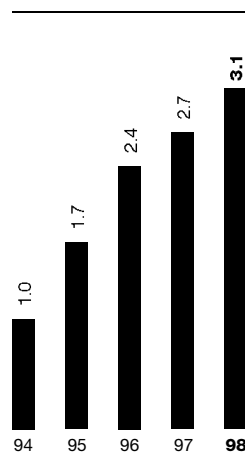


International call turnover declined by 14.2% in the 1998 financial year to £1,553 million after declining by 8.6% in the 1997 financial year. This was primarily the result of price reductions averaging 20% and 13% in the two years, respectively, and the impact of the strengthening of sterling, partially offset by strong volume growth of 9% and 7%, respectively. BT is reducing prices substantially on most international routes.

Turnover from the fixed network line rentals grew by 5.2% in the 1998 financial year to £2,957 million after increasing by 4.7% in the 1997 financial year. The increased turnover was the combined result of the growth in business lines and 3% rental price increases in both July 1996 and July 1997. The number of business lines grew by 5.0% in the 1998 financial year and by 5.3% in the 1997 financial year with ISDN services mainly contributing to this growth. The numbers of residential lines declined slightly in both years due to the competition from cable operators. Overall, BT's total fixed network lines were maintained at 27.6 million in the 1998 financial year after growing by 0.9% in the 1997 financial year.

Private circuit turnover rose by 2.2% in the 1998 financial year to £1,149 million after increasing by 6.4% in the 1997 financial year. Demand for digital KiloStream and MegaStream services continued at a high level in both years, supported by a significant migration from analogue circuits.

**Cellnet customers (millions)**



Mobile communications turnover increased by 14.8% in the 1998 financial year to £1,089 million following growth of 10.9% in the previous financial year. This reflected the

14% and 12.9% growth in Cellnet's customer-base in the two years, respectively, offset by the effect of reductions in mobile call prices. Cellnet had 3.1 million customer connections at 31 March 1998, 75% of which were on its digital GSM network.

The strong growth in BT's sales of its advanced services, including FeatureNet, its Syncordia Solutions operation, incorporating managed data networks, and Syntegra, the group's systems integration business, were the main elements in the increase of 29% in other sales and services in the 1998 financial year to £2,606 million and the 23% growth in the 1997 financial year. Other significant increases in turnover came from BT's overseas operations and interconnect charges.

BT's turnover from its overseas operations grew strongly. Concert services to multinational customers provided much of the growth in the 1998 financial year. Newly-acquired systems integration businesses in Europe accounted for about half of the growth in the 1997 financial year with Concert services providing much of the balance.

Turnover from UK operators for interconnect charges rose from £265 million in the 1996 financial year to £319 million in the 1997 financial year and to £496 million in the 1998 financial year. These increases reflect the growing market share of BT's UK competitors and the increasing level of traffic flowing into BT from their networks. There was also a corresponding increase in the payments made by BT to these operators for traffic passing to their networks.

**Other operating income**

Under the terms of an agreement among BT, MCI and WorldCom, BT received US \$465 million on 12 November 1997 as the break-up fee and partial reimbursement of expenses incurred on the BT/MCI merger agreement. This receipt, net of relevant expenses incurred in the 1998 financial year, has been included as an exceptional profit of £238 million in other operating income in the group's profit and loss account for this year.

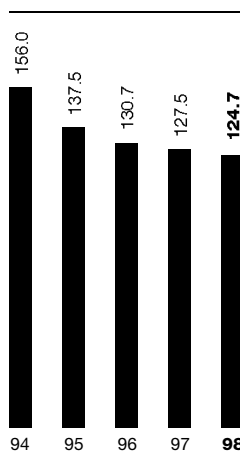
**Operating costs**

Total operating costs increased by 4.7% in the 1998 financial year to £12,355 million after increasing by 3.0% in the 1997 financial year. As a percentage of turnover, operating costs decreased from 79.3% in the 1996 financial year to 79.0% in the 1997 and 1998 financial years.

	<b>1998</b> £m	1997 £m	1996 £m
Staff costs	<b>3,917</b>	3,778	3,680
Own work capitalised	<b>(424)</b>	(399)	(417)
Depreciation	<b>2,395</b>	2,265	2,189
Payments to telecommunication operators	<b>1,600</b>	1,476	1,383
Other operating costs	<b>4,761</b>	4,309	4,193
Total operating costs, before redundancy charges	<b>12,249</b>	11,429	11,028
Redundancy charges	<b>106</b>	367	421
Total operating costs	<b>12,355</b>	11,796	11,449

Staff costs increased by 3.7% in the 1998 financial year to £3,917 million, after rising by 2.7% in the 1997 financial year. The increase in the 1998 financial year was the result of the effects of the annual pay awards and compensation for the special dividend, offset by savings resulting from reduced pension costs. The compensation of £120 million for the special dividend is for those employees holding unexercised rights, mainly under group-wide sharesave schemes, which lost value on the payment of the special dividend in September 1997.

**Employees (thousands)**



The allocation for the employee share ownership scheme in the 1998 and 1997 financial years was £64 million, representing 2% of pre-tax profit for those years. In the 1996 financial year approximately 1% was allocated. In the 1997 financial year, the increase in staff costs was the result of this higher allocation for the employee share ownership scheme as well as the annual pay awards and staff costs in

acquired subsidiaries, offset by savings resulting from staff reductions.

The depreciation charge increased by 5.7% in the 1998 financial year to £2,395 million after increasing by 3.5% in the 1997 financial year, reflecting BT's continuing high level of investment in its networks.

Payments to other telecommunication operators grew by 8.4% in the 1998 financial year to £1,600 million after increasing by 6.7% in the 1997 financial year, primarily as a result of the growing number of calls terminating on UK competitors' networks. Payments to overseas operators for incoming calls terminating in the UK fell significantly in both years as a consequence of falling prices and the strengthening of sterling more than offsetting call volume growth.

Other operating costs, which rose by 10.5% in the 1998 financial year to £4,761 million and by 2.8% in the 1997 financial year, include the maintenance and support of the networks, accommodation and marketing costs, the costs of BT's overseas operations and the cost of sales of customer premises equipment. In the UK's increasingly competitive telecommunications market, BT is spending significantly more on its marketing programmes, including extensive TV advertising, and this has been one of the three main factors behind the increase in costs. The others have been the costs incurred in supporting the recent rapid expansion of Cellnet and Concert.

Redundancy costs of £106 million were incurred in the 1998 financial year, compared with £367 million in the 1997 financial year and £421 million in the 1996 financial year. The significant reduction in costs in the 1998 financial year is a consequence of a surplus arising in BT's main pension scheme. In view of this surplus, described below, and in accordance with BT's accounting policies, redundancy charges for the 1998 financial year do not include the costs of the incremental pension benefits provided to early retirees. In the 1997 and 1996 financial years, redundancy costs included £258 million and £266 million relating to incremental pension benefits, respectively.

### **Operating profit**

Operating profit for the 1998 financial year of £3,657 million was £412 million (12.7%) higher than in the previous year. In the 1997 financial year, operating profit was 4.7% higher than in the 1996 financial year.

### **Associates**

As a consequence of the termination of the BT/MCI merger agreement and BT's agreement with WorldCom to vote in favour of the proposed MCI/WorldCom merger, BT ceased treating MCI as an associate from 1 November 1997. The group's share of its associates' results for the 1998 financial year incorporates a loss of £27 million, representing BT's share of MCI's results up to that date, which include a special charge of £63 million.

Excluding MCI, the group's share of losses of associates totalled £225 million in the 1998 financial year. The principal loss arose in Viag Interkom which is building its initial network to compete in the German market. Smaller losses were incurred by Telfort in the Netherlands and Cegetel in France, which has been an associate since September 1997.

The group's £139 million share of profits of associated undertakings in the 1997 financial year consisted primarily of the company's share of MCI's profits less BT's share of losses in its joint ventures in Germany and Sweden which were commencing establishing their businesses. BT's share of MCI's pre-tax profit for the 1997 financial year amounted to £175 million, under BT's accounting policies, and was significantly higher than the corresponding figure of £101 million for the 1996 financial year which had been adversely affected by a restructuring charge, BT's share of which was £73 million.

BT expects that its associates in Europe as a whole will continue to incur losses for the next two to three financial years.

### **Interest charge and bond repurchase premium**

Following payment of the special dividend in September 1997, described below, the group's borrowings have increased significantly and its interest charge has risen commensurately. Consequently, in the 1998 financial year, the group's net interest charge of £249 million was £120 million higher than the interest charge in the previous year. Interest cover represents 14.7 times operating profit and is expected to continue at a comfortable level.

The net interest charge of £129 million for the 1997 financial year was £41 million lower than the interest charge in the 1996 financial year. The group's strong positive cash flow was the main contributor to this lower charge which was covered 25.2 times by operating profit.

During August 1996, the company took the opportunity to repurchase two of the three then-remaining series of Government held bonds for £422 million, at an effective premium of £60 million which was charged against profit in the 1997 financial year in accordance with UK accounting standards. The last-remaining series was repaid on its maturity in March 1997. The repurchase has reduced the overall effective interest rate on BT's borrowings.

**Profit and taxation**

The group's profit before taxation for the 1998 financial year was £3,219 million, compared with £3,203 million in the 1997 financial year and £3,019 million in the 1996 financial year.

The tax charge for the 1998 financial year includes BT's £510 million share of the UK Government's windfall tax on certain privatised companies, imposed in July 1997. The first £255 million instalment was paid on 2 December 1997 with the second being payable in December 1998.

The ordinary tax charge of £978 million as a percentage of profit before taxation was 30.4%, compared with 34.4% for the 1997 financial year and 34.0% for the 1996 financial year. The group's ordinary tax charge for the 1998 financial year is an effective 31.5% of pre-tax profit, excluding the MCI merger break-up fee which is effectively subject to a lower tax charge under UK capital gains tax legislation. This effective tax charge reflects the lower 31% rate of corporation tax set for the year, compared with 33% set for the previous two financial years. The higher effective rate in the 1997 financial year was due to the premium on the bond repurchase only being partially deductible for tax purposes.

**Earnings and dividends**

Earnings per share, based on a profit for the 1998 financial year of £1,706 million, were 26.7 pence. Earnings before the two exceptional items were 31.7 pence per share, in comparison with 32.8 pence for the 1997 financial year and 31.6 pence for the 1996 financial year.

As originally announced in November 1996, the company paid a special dividend of 35 pence per share in September 1997. This dividend absorbed £2,244 million. The Board believed that shareholder value and earnings growth would be enhanced through the introduction of more gearing which was achieved with this payment.

To maintain the yield on the company's shares, the Board has adjusted the level of ongoing annual dividends

to take into account the effect of the special dividend. This adjustment was first made for the interim dividend for the year ended 31 March 1998.

The ordinary dividends paid and recommended for the 1998 financial year of 19.0 pence per share represent a 6.4% increase on the previous year, adjusted for the effect of the special dividend, and are covered 1.8 times by earnings, excluding the effect of the windfall tax. These dividends comprise the interim dividend of 7.55 pence per share, which was paid in February 1998, and the proposed final dividend of 11.45 pence per share which, if approved at the annual general meeting, will be paid on 21 September 1998 to shareholders on the register on 7 August 1998. The proposed final dividend is that forecast by the Board in its announcement in October 1997. These ordinary dividends will absorb £1,220 million. For the 1997 and 1996 financial years, ordinary dividends of 19.85 pence and 18.7 pence per share, respectively, were paid or recommended.

**Financing**

	1998 £m	1997 £m	1996 £m
Net cash inflow from operating activities	<b>6,076</b>	6,192	5,834
Net cash outflow for returns on investments and servicing of finance	<b>(160)</b>	(220)	(150)
Tax paid	<b>(1,886)</b>	(1,045)	(784)
Capital expenditure and financial investment	<b>(3,108)</b>	(2,820)	(2,500)
Acquisitions and disposals	<b>(1,501)</b>	(252)	(132)
Equity dividends paid	<b>(3,473)</b>	(1,217)	(1,138)
Net cash inflow (outflow) before management of liquid resources and financing	<b>(4,052)</b>	638	1,130
Management of liquid resources	<b>2,247</b>	(504)	(1,317)
Net cash inflow (outflow) from financing	<b>1,794</b>	(224)	215
Net increase (decrease) in cash and cash equivalents	<b>(11)</b>	(90)	28
Decrease (increase) in net debt	<b>(3,860)</b>	849	1,319

Net cash inflow from operating activities of £6,076 million in the 1998 financial year compared with £6,192 million in the 1997 financial year and £5,834 million in the 1996 financial year. The higher net cash inflow in the 1997 financial year

than in the 1998 or 1996 financial years reflected a reduction in working capital in the 1997 financial year.

Tax paid in the 1998 financial year totalled £1,886 million. It was particularly high because of £561 million advance corporation tax paid in October 1997 in respect of the special dividend and £255 million paid in December 1997 as the first windfall tax instalment. This advance corporation tax will reduce the group's overall tax payment in the 1999 financial year. The tax paid in the 1997 financial year, principally relating to the prior year's profit, amounted to £1,045 million and the increase of £261 million on the previous year was mainly due to the higher level of profit made in the 1996 financial year compared with the prior year.

The UK Government is changing the pattern of corporation tax payments from April 1999 by requiring companies to pay tax in quarterly instalments starting at the half year stage in each financial year. The changes are being phased in and are in place of the current main single corporation tax payment made nine months after the financial year end and advance corporation tax payments associated with dividends. It is expected that the effect of these accelerated payment arrangements will be to increase the tax payments to be made by the group in the 2000 and 2001 financial years, notwithstanding the reduction in the standard rate of corporation tax to 30% announced by the Government for those years.

Net cash outflow of £3,108 million for capital expenditure and financial investment in the 1998 financial year mainly comprises expenditure on plant, equipment and property and compares with £2,820 million in the 1997 financial year and £2,500 million in the 1996 financial year.

The net cash outflow on acquisitions totalled £1,501 million in the 1998 financial year, the principal part of which was the investment in Cegetel.

Equity dividends paid in the 1998 financial year totalled £3,473 million and included the special dividend of £2,244 million in September 1997. In the two previous financial years dividends of £1,217 million and £1,138 million were paid.

The resulting cash outflow, before liquid resources and financing, of £4,052 million in the 1998 financial year was mainly financed by the issue of new loans in the first two months of the year, principally two Eurobonds totalling

US \$2,500 million, and by using the group's existing short-term investments. In the two previous financial years, the group had positive net cash inflows before financing of £638 million and £1,130 million, respectively.

The cash outflow caused mainly by the special dividend payment and the investment in Cegetel resulted in net debt rising to £3,977 million at 31 March 1998. Balance sheet gearing stood at 36 per cent at that date.

In the 1998 financial year, the group borrowed £1,637 million in long-term loans and long-term debt repaid totalled £338 million. BT issued a US\$1.5 billion five-year 6¾% Eurobond in April 1997 and a US\$1.0 billion ten-year 7% Eurobond in May 1997 in preparation for the group's cash requirements later in 1997.

The cash dividend payment has been reduced by £18 million as the company's scrip dividend scheme operated for the first time in the 1998 financial year. 3.8 million new shares were issued as a consequence as further described in note 22 to the financial statements.

#### **Treasury policy**

The group has a centralised treasury operation. Its primary role is to manage liquidity, funding, investment and the group's financial risk, including risk from volatility in currency and interest rates and counterparty credit risk. The treasury operation is not a profit centre and the objective is to manage risk at optimum cost.

The Board sets the department's policy and its activities are subject to a set of controls commensurate with the magnitude of the investments and borrowings under its management. Counterparty credit risk is closely monitored and managed within controls set by the Board. Derivative instruments including forward foreign exchange contracts are entered into for hedging purposes only.

#### **Capital resources and foreign currency exposure**

The directors have a reasonable expectation that the group has adequate resources to continue in operational existence for the foreseeable future and therefore they continue to adopt the going concern basis in preparing the financial statements.

At 31 March 1998, the group had cash and short-term investments of £793 million. At that date, £550 million of short-term debt was outstanding. In addition, the group had

unused committed short-term bank facilities, amounting to approximately £786 million at 31 March 1998, in support of a commercial paper programme or other borrowings. The group also has substantial uncommitted short-term bank facilities.

The gearing or ratio of net debt (borrowings net of cash and short-term investments) to shareholders' equity and minority interests was 36.1% at 31 March 1998, compared with 1.6% at 31 March 1997. The group had £3,977 million net debt at 31 March 1998, an increase of £3,801 million in the year. Net debt has increased substantially during the course of the 1998 financial year primarily as a result of the special dividend payment and the investment in Cegetel.

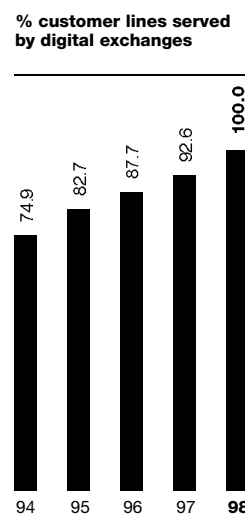
The majority of the group's long-term borrowings has been, and is, subject to fixed interest rates. The group has entered into interest rate swap agreements with commercial banks and other institutions to vary the amounts and period for which interest rates are fixed. At 31 March 1998, the group had outstanding interest rate swap agreements with notional principal amounts totalling £1,489 million.

Most of the group's current turnover is invoiced in pounds sterling, and most of its operations and costs arise within the UK. The group's foreign currency borrowings, which totalled £2,316 million at 31 March 1998, are used to finance its UK operations and to finance the groups' overseas investments, including MCI, in order to reduce the currency exposure on the underlying assets. Cross currency swaps and forward foreign exchange contracts have been entered into to reduce the foreign currency exposure on the group's operations and the group's net assets. The group also enters into forward foreign exchange contracts to hedge investment, interest expense, purchase and sale commitments. The commitments hedged are principally US dollars. As a result of these policies, the group's exposure to foreign currency arises mainly on the residual currency exposure on overseas investments and on any imbalances between the value of outgoing, transit and incoming international calls with overseas telecommunication operators. To date, these imbalances have not been material. As a result, the group's profit has not been materially affected by movements in exchange rates.

The group is not significantly exposed to changes in interest rates. Based upon the composition of net debt at 31 March 1998, a one percentage point change in interest rates would change the group's interest expense by less than £10 million. Apart from the potential proceeds from the sale of the group's holding in MCI, the group is also not significantly exposed to changes in currency rates. Excluding the MCI investment, a 10% change in sterling against major currencies would cause the group's net assets at 31 March 1998 to change by less than £150 million, with insignificant effect on the group's profit. Because the foreign exchange contracts are entered into as a hedge of sales and purchases, a change in the fair value of the hedge is offset by a corresponding change in the value of the underlying sale or purchase.

If market conditions are appropriate, the company will consider making repurchases of its own shares. Authority to purchase up to 10% of the company's issued share capital is to be requested by the directors at the annual general meeting of shareholders to be held in July. Decisions on the amount of cash, if any, to be used in buying back shares and the precise timing will depend in part on market conditions and other opportunities that exist for the deployment of the group's cash resources.

**Capital expenditure**



Capital expenditure on plant, equipment and property totalled £3,030 million in the 1998 financial year, compared

with £2,719 million in the 1997 financial year and £2,771 million in the 1996 financial year. There has been an increased emphasis on enhancing the intelligence of the network to enable customers to benefit from advanced services and improving the network's capacity for carrying high-speed data. Additionally, Cellnet has continued expanding its digital cellular GSM network.

The group expects capital expenditure in the 1999 financial year to be at a level similar to that of the 1998 financial year. BT expects that future capital expenditure will be provided from net cash inflows from operating activities supplemented, if appropriate, by external financing.

### Acquisitions and joint ventures

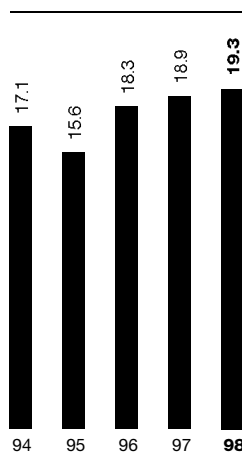
The group has invested over £1,650 million in the 1998 financial year on acquiring interests in associated companies and other investments and providing their further funding. The most significant investment was the completion in September 1997 of the group's acquisition of a 26% interest in Cegetel for a total of £1,029 million. Cegetel, the second French telecommunications operator, has an 80% interest in SFR, a leading mobile provider in France. Over £400 million has been invested in other European telecommunications companies in the year, primarily in Germany, Spain and the Netherlands. The goodwill arising on all of these acquisitions amounted to £869 million out of a total of £937 million, which has been written off to reserves.

In the previous financial year, the group acquired the Rijnhaave group, a Netherlands-based systems integration business in April 1996 and, in March 1997, completed the formation of Telfort, a joint venture with NS, the Dutch railways company, to offer telecommunication services in that country. In February 1997, BT agreed to acquire the 50% interest in its Spanish joint venture it did not already own, thereby obtaining full control; this transaction was completed in July 1997. The goodwill arising on these acquisitions amounted to £166 million; the remaining goodwill taken to reserves in the 1997 financial year of £33 million mainly related to BT's share of goodwill arising on MCI's acquisitions, principally on its joint venture in Mexico.

### Return on capital employed

The group made a return of 19.3% on the average capital employed, on a historical cost basis, in its business in the year ended 31 March 1998, compared with returns of 18.9% and 18.3% in the two previous years.

% return on capital employed



### Pensions

An actuarial valuation of BT's main pension fund as at 31 December 1996 was completed during the 1998 financial year. This valuation revealed the fund to be in surplus to an amount of approximately £66 million, with assets of the fund at £19,879 million at that date covering just over 100% of the fund's liabilities, in contrast to an asset coverage of 97% at 31 December 1993. The improvement in the funding position principally arose from the strong return on the fund's assets in the three intervening years more than outweighing the impact of redundancies on the fund. The actuarial valuation took into account the effect of the Government's measures in July 1997 to end pension funds' ability to reclaim the tax credit associated with UK companies' dividends. Without this measure the surplus in the fund would have been significantly higher.

From 1 April 1997, the annual pension charge was based on the December 1996 valuation and was £114 million lower than the charge of £291 million in the 1997 financial year. This revised charge took into account the amount of the pension provision which had been established over recent years in the group's accounts and which stood at £1,224 million at 31 March 1998. Additionally, under UK accounting standards, the cost of providing incremental pension benefits for early leavers has no longer been charged against the profit in the period in which people leave, since the latest actuarial valuation of the pension fund indicates a surplus.

The actuarial valuation confirmed that the group's contribution into the fund should continue at 9.5% of employees' pensionable pay.

The number of retired members and other current beneficiaries in the pension fund has been increasing in recent years and, at 31 December 1997, was approximately 45% higher than the number of active members.

Consequently, BT's future pension costs and contributions will depend to a large extent on the investment returns of the pension fund and could fluctuate in the medium term.

#### **MCI/WorldCom merger**

On 1 October 1997, WorldCom announced its intention to offer shares in its company to MCI shareholders as an alternative to the proposed BT/MCI merger. Following an improved offer from WorldCom in November 1997, BT agreed that it would support the proposed merger of MCI with WorldCom to which the MCI board had agreed on the same day. Consequently, the proposed merger between BT and MCI, originally announced in November 1996, was terminated.

Under the WorldCom agreement, BT will sell its holding of 136 million Class A common shares in MCI to WorldCom for US\$51 per share in cash at the time the MCI/WorldCom merger is completed. WorldCom expects the merger, which is subject to regulatory clearance, to be completed later in 1998. At that time, BT will account for the proceeds of approximately US\$7 billion and the consequent profit on the sale of its investment, which will depend on the sterling:US dollar exchange rate.

Also under the WorldCom agreement, BT has agreed to acquire MCI's 24.9% equity interest in the Concert Communications Services joint venture at a price to be negotiated.

#### **Year 2000**

The BT Year 2000 Programme deals with all the issues arising from the inability of many computer systems and electronic devices to deal with the year 2000 date change and other critical event-related dates. BT takes the Year 2000 issue very seriously and has established a comprehensive group-wide business programme which is monitored regularly at Board level. BT has estimated the total cost to be in the region of £300 million representing primarily the upgrading of existing software and including internal costs. Current forecasts indicate that the programme is being managed within budget.

The programme has been in place since 1995 and BT aims to achieve compliance with substantially all of its major systems by 31 December 1998. BT recognises, however, its

dependence on suppliers with whom it is working closely. Both BT's suppliers and the BT programme have been making progress and the company's intention is that telecommunications services provided by BT in the UK will not be significantly affected and that customers will continue to receive the current levels of service and care. One of BT's current priorities is to build the same level of confidence in international services which are heavily dependent on overseas telecommunications companies. Although BT does not yet have sufficient information to guarantee current levels of service to all international destinations, it has been instrumental in a number of initiatives aimed at improving the global situation and BT will continue to work closely with government, international bodies and with the companies themselves.

BT is also working actively with its customers, suppliers and UK organisations to secure appropriate contingency plans, both internally and at a national level.

#### **Impact of inflation**

In accordance with a requirement of BT's main licence, the group's annual accounts for the 1997 financial year prepared on a current cost basis were published in September 1997. These accounts showed that the group's current cost profit before tax was £2,419 million, compared with £3,203 million under the historical cost convention. The group's current cost total assets at 31 March 1997 were £29,225 million, compared with £25,062 million under its historical cost accounts. The current cost accounts for the 1998 financial year are to be published by 30 September 1998.

#### **Environment**

When removing old analogue exchange equipment from buildings, BT recycles the metal content and takes special care to ensure that any hazardous materials are properly disposed. Although BT receives proceeds from the sale of recovered materials, this is more than offset by the cost of dealing with hazardous materials, contracting and planning their removal and preparing the released site for further development. BT believes that the total cost of dealing with these hazardous materials will not be significant.

### **Goodwill and intangibles**

From the 1999 financial year, BT will be adopting the new UK accounting standard on goodwill and intangibles (FRS10). Under this standard, all goodwill arising on acquisitions made after 1 April 1998 will be capitalised and amortised over its useful economic life.

The net impact on the group's accounts of this change will depend on the extent of any acquisitions which may be made and the level of goodwill involved.

### **Segmented information**

BT essentially operates as a unitary business, providing an integrated range of telecommunications products and services. Accordingly, BT does not publish separately the operating profit for the various sources of turnover described above. In the 1998 financial year, approximately 96% of the group's turnover was generated by operations in the UK, compared with 97% in the 1997 financial year and 98% in the 1996 financial year.

BT is required under its main licence to publish disaggregated financial information for various activities of the group, which have been used as the basis of charges paid by other telecommunication operators in the UK for the use of BT's network. The activities presented separately in the regulatory financial statements do not necessarily correspond with any businesses separately managed, funded or operated within the group. The results set out in these statements for the 1997, 1996 and 1995 financial years showed that the group's operating profit is derived predominantly from local, national and international calls, after taking account of an operating deficit arising on the provision of exchange lines.

For its 1999 financial year, BT will be providing disaggregated financial information in accordance with the requirements of the US SFAS No 131 which requires such information to be analysed in a similar manner to that used by management in managing the business.

### **US GAAP**

The group's net income and earnings per share for the three financial years ended 31 March 1998 and shareholders' equity at 31 March 1998 and 1997 under US Generally Accepted Accounting Principles (US GAAP) are shown in note 30 to the financial statements.

Differences between UK GAAP and US GAAP include results of the differing accounting treatment of pension costs, redundancy costs, intangible assets, goodwill,

deferred taxation, capitalisation of interest and dividends. The earnings per share under US GAAP are calculated in accordance with SFAS 128 for the first time. Prior year figures have been restated. However, there are no significant differences in earnings to those determined under the previous method. Cash flow information under the US GAAP presentation is also shown in note 30.