

Financial review

Introduction

BT's earnings of 46.3 pence per share for the year ended 31 March 1999 (the 1999 financial year) compare with 26.6 pence for the 1998 financial year and 32.8 pence for the 1997 financial year. Of the earnings in the 1999 financial year, 11.6 pence per share represented net exceptional income mainly relating to the sale of the group's investment in MCI Communications Corporation in September 1998. Earnings for the 1998 financial year were affected by net exceptional charges of 5.1 pence per share, relating to the windfall tax, partially offset by a fee received relating to the termination of the BT/MCI merger. Earnings before exceptional items of 34.7 pence per share for the 1999 financial year compare with an equivalent 31.7 pence and 32.8 pence for the 1998 and 1997 financial years, respectively.

	1999 £m	1998 £m	1997 £m
Total turnover			
– ongoing	18,223	16,039	15,021
Group's share of ventures' turnover – ongoing	(1,270)	(399)	(86)
Group turnover			
– ongoing	16,953	15,640	14,935
Other operating income	168	372	106
Operating costs	(13,305)	(12,355)	(11,796)
Group operating profit	3,816	3,657	3,245
Group's share of ventures' profits (losses)	(342)	(196)	184
Total operating profit	3,474	3,461	3,429
Profit on sale of fixed asset investments and group undertakings	1,107	63	8
Net interest and premium payable	(286)	(310)	(234)
Profit before taxation	4,295	3,214	3,203
Taxation – ordinary	(1,293)	(977)	(1,102)
– windfall	–	(510)	–
Profit after taxation	3,002	1,727	2,101
Minority interests	(19)	(25)	(24)
Profit for the financial year	2,983	1,702	2,077
Basic earnings per share	46.3p	26.6p	32.8p
Basic earnings per share before exceptional items	34.7p	31.7p	32.8p

The results for the 1999 and 1998 financial years benefited from the strong growth in demand for the group's products and services. In the 1999 financial year, Internet and mobile phone usage expanded rapidly and this led to increased turnover and profit. In the 1998 financial year, the buoyant

UK economy had a beneficial effect on the results. Our new ventures in Continental Europe and Asia Pacific which we have established, or in which we have acquired interests, in the past two to three years, are contributing significantly to our turnover growth. However, the initial losses being incurred in their development stages are, as anticipated, adversely affecting the group's results. We continue to be affected by the tight regulatory regime in the UK and intense competition. Price reductions, including those imposed by the price control formulae, totalled approximately £500 million following reductions of over £750 million in the 1998 financial year and £800 million in the 1997 financial year. The 1999 and 1998 financial years' results included lower redundancy costs in comparison with the 1997 financial year.

The group's interest in MCI was sold in September 1998 on the completion of the MCI/WorldCom merger. We recognised a pre-tax profit of £1,133 million on the sale in the 1999 financial year; this followed the £273 million fee we received in November 1997 on announcement of their agreed merger, as compensation for the break-off of the merger we had planned with MCI. We ceased equity accounting for MCI as an associate on 31 October 1997. At the same time as we disposed of our interest in MCI in September 1998, we acquired the minority interest owned by MCI in Concert Communications Services (Concert). Concert is to be transferred to our proposed global venture with AT&T later in 1999, once we have obtained regulatory clearances.

Accounting and presentation changes

A number of changes have been made to the presentation of the group's results, largely due to our implementing several new UK financial reporting standards (FRSs) in the 1999 financial year. The group's proportional share of its associates' and joint ventures' (ventures) turnover is now shown in the group profit and loss account. We are also required to show our share of our ventures' results at the operating level in that statement with our share of their interest charge or income being aggregated with the group's. Additionally, BT's share of its joint ventures' assets and liabilities is shown on the face of the group balance sheet. Goodwill arising on acquisitions completed after 1 April 1998 is being capitalised and amortised over their economic lives.

Other additional disclosures and minor changes in the financial statements have been made as a result of implementing FRSs 9 to 14 in the year and additional

disclosures on segmental reporting and pensions have been included in accordance with two new US accounting standards, SFASs Nos. 131 and 132. We have also taken the opportunity to expand the turnover analysis to reflect the changing nature of the group. Prior year figures have been restated where necessary and practical, but there have been no significant changes to previously reported profits or earnings per share. Further details are set out in note 1 to the financial statements.

Regulation and prices

BT has been operating under a new retail price control from 1 August 1997 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 retail price control is estimated to have covered services representing about 16% of the group's turnover for the year to 31 March 1999. In the current price control year to 31 July 1999, BT has reduced its prices by the required reduction of 0.73%. The equivalent reduction in the previous control year was 1.56%.

The determination of most of BT's interconnect charges with other UK operators was changed, from 1 October 1997, from one based on fully allocated historical costs to a long-run incremental cost basis. Annual determinations have been replaced with a system based on RPI minus price caps. There was an initial reduction in charges of 10% in the 1998 financial year and this is being followed by annual reductions over a four-year period based on a RPI minus 8 price cap.

The period to 31 July 1997, affecting the 1997 and 1998 financial years, 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 final price control year under this formula, BT reduced its prices by about 5% in the year to 31 July 1997.

In March 1998, Oftel referred BT, BT Cellnet and Vodafone, BT Cellnet's direct competitor, to the MMC for investigation into the charges for calls made from BT's fixed network to BT Cellnet and Vodafone's networks. In its report, the MMC required BT to reduce its charges to its customers by around 25% in the 2000 financial year and an effective annual RPI minus 8.5 cut for a further two years. The initial 25% reduction took effect on 30 April 1999. The company believes that the impact of these price reductions is not likely to be significant to the group's

financial position in light of the experience of significant price cuts in the last two financial years and in view of the continuing volume growth in services provided.

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 the United States.

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. We estimate that BT had 70% of the market for national calls for the 1999 financial year, compared with 75% and 79% in the 1998 and 1997 financial years, respectively, and supplied 86% of the exchange lines in the UK at 31 March 1999, compared with 89% and 90% at 31 March 1998 and 1997, respectively. Additionally, we estimate that BT had 81% of the market for local calls for the 1999 financial year, compared with 85% and 90% in the 1998 and 1997 financial years, respectively. We believe that we no longer have a dominant market position for outgoing international calls from the UK.

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

In an environment of strong competition, BT Cellnet had 30% of the market based on the number of customer connections at 31 March 1999, compared with 34% at 31 March 1998 and 38% at 31 March 1997. There has also been a downward pressure on prices.

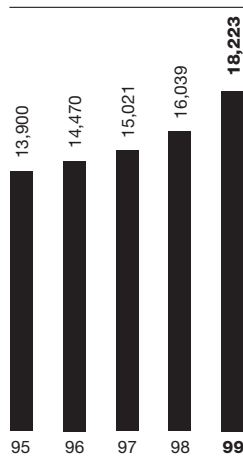
The group has seen some diversion of demand from its fixed network as a result of the growth of other licensed operators' activities. This diversion might intensify once BT's fixed-line customers are able to pre-select their carrier for national and international calls, as required under an EU directive, expected to be implemented by BT in 2000.

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 0.6% in the year ended 31 March 1999, compared with 2.9% and 3.0% in the previous two years.

Turnover

Total turnover (£m)
YEARS ENDED 31 MARCH



Total turnover in the 1999 financial year of £18,223 million includes BT's proportionate share of its ongoing ventures' turnover of £1,270 million. This total turnover grew by 13.6% in the 1999 financial year after growing by 6.8% in the 1998 financial year compared with the 1997 financial year. For ease of comparison, both the 1998 and 1997 financial years exclude BT's share of MCI's turnover while it was BT's associate of £1,372 million and £2,358 million, respectively. BT's new ventures in Europe and Asia Pacific accounted for around a third of these increases in turnover in both years.

Group turnover, excluding the ventures, grew by 8.4% to £16,953 million in the 1999 financial year after growing by 4.7% in the 1998 financial year compared with the 1997 financial year. The strong growth in demand for the group's products and services of approximately 12% in the 1999 financial year and approximately 10% in the 1998 financial year was partially offset by the effect of price reductions which averaged approximately 3% across the business in the 1999 financial year, compared with approximately 5% in the 1998 financial year. Both mobile and fixed-network calls in the UK made strong contributions to the group's activities in the 1999 financial year, as a result of the significant growth in BT Cellnet's mobile customer base and increased Internet usage.

The group's ongoing turnover is analysed as follows:

	1999 £m	1998 £m	1997 £m
Inland calls	5,178	4,924	4,874
Exchange lines	3,337	3,180	3,033
International calls	1,501	1,553	1,809
Mobile communications	1,400	1,089	949
Private circuits	1,165	1,149	1,124
Customer premises equipment supply	870	896	914
Receipts from UK operators	645	496	319
Yellow Pages and other directories	491	466	438
Other UK sales and services	1,770	1,332	994
Non-UK operations	596	555	481
Group turnover	16,953	15,640	14,935
Share of ventures' turnover	1,270	399	86
Total turnover	18,223	16,039	15,021

In the 1999 financial year, a significant increase in calls to mobile phones and the increased use of the Internet were the main factors behind an increase in inland calls over BT's fixed network, particularly in the second half of the year. The strong inland call volume growth of 9% was partially offset by the price reduction effect, resulting in total call turnover increasing by 5.2% in the year to £5,178 million. 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. Fixed network to mobile calls and inbound services, including 0800 numbers, were the main areas of the strong volume growth in the 1998 financial year.

Price reductions had an impact on turnover from inland calls made over the fixed network for the fifth year in succession. Reductions in **Freefone** and **Lo-call** prices charged to service providers and lower national and fixed network to mobile call prices were the main reductions affecting the 1999 financial year. The combined effect of the price changes totalled over £160 million in the 1999 financial year, which was equivalent to a 3% reduction in call prices following falls of 6% and 7% in the previous two years.

Turnover from the fixed-network lines grew by 4.9% in the 1999 financial year to £3,337 million after increasing by 4.8% in the 1998 financial year. The increased turnover was the combined result of the growth in business lines and rental price increases. The number of business lines grew by 6.1% in the 1999 financial year and by 5.0% in the 1998 financial year, with ISDN services being the main driver behind this growth. The numbers of residential lines declined slightly

Exchange lines turnover (£m)
YEARS ENDED 31 MARCH



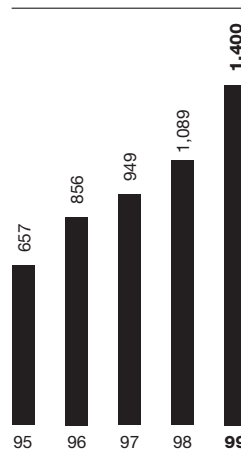
in both years due to the competition from cable operators offset in part by the large number of BT customers installing second lines. Overall, BT's total fixed-network lines grew by 1.4% in the 1999 financial year to 28.1 million and were maintained at 27.6 million in the 1998 financial year.

International call turnover declined by 3.3% in the 1999 financial year to £1,501 million after declining by 14.2% in the 1998 financial year. This was primarily the result of price reductions averaging 12% and 20% in the two years, respectively, and the impact of the strengthening of sterling in the 1998 financial year, partially offset by strong volume growth of 11% and 9%, respectively. Transit call volumes increased significantly in the 1999 financial year.

Mobile communications turnover increased by 29% in the 1999 financial year to £1,400 million, following growth of 14.8% in the previous financial year. This reflected the 47% and 14% growth in BT Cellnet's customer-base in the two years, respectively, offset by the effect of reductions in mobile call prices. Over 1.4 million new customers were connected to BT Cellnet's network in the 1999 financial year, partially due to the success of the new "pre-paid" mobile phone introduced in the second half of the year. BT Cellnet had 4.5 million customer connections at 31 March 1999, over 90% of which were connected to its digital GSM network.

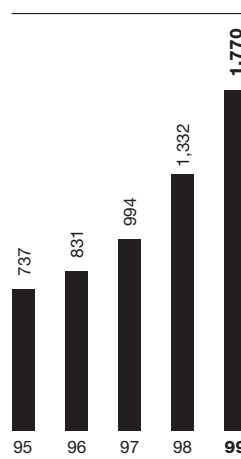
Private circuit turnover grew by 1.4% in the 1999 financial year to £1,165 million after increasing by 2.2% in the 1998 financial year. Although demand for digital KiloStream and MegaStream services continued at a high level in both years, supported by a significant migration from analogue circuits, price reductions in the 1999 financial year prevented any significant turnover growth.

Mobile communications turnover (£m)
YEARS ENDED 31 MARCH



Turnover from UK operators for interconnect charges increased from £319 million in the 1997 financial year to £496 million in the 1998 financial year and to £645 million in the 1999 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 a large corresponding increase in the payments made by BT to these operators for traffic passing to their networks.

Other UK sales and services turnover (£m)
YEARS ENDED 31 MARCH



BT's other UK sales and services mainly comprise outsourcing, data and multimedia services. These include Syncordia Solutions, FeatureNet, Syntegra, videoconferencing, and broadcast and other multimedia services. Each of these services contributed strongly to the 33% increase in turnover for this category, which totalled £1,770 million in the 1999 financial year, and the 34% growth in turnover in the previous financial year.

BT's turnover from its overseas operations grew by 7.4% in the 1999 financial year after growing by 15.4% in the previous year. Concert services to multinational customers provided much of the growth in the 1998 financial year and these, combined with Syntegra's services to non-UK customers, led to the growth in the 1999 financial year.

BT's share of its ventures' turnover, excluding MCI, rose from £86 million in the 1997 financial year to £399 million in the 1998 financial year and to £1,270 million in the 1999 financial year. This growth was due to our establishment and acquisition of interests in ventures in Europe and Asia Pacific over the past three years. In the 1999 financial year, £1,149 million of the total arose from ventures located outside the UK. The principal contributors were Cegetel (£578 million), Airtel (£157 million), Viag Interkom (£82 million) and LG Telecom (£81 million from October 1998).

Other operating income

In the 1998 financial year, BT received US\$465 million 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 that financial year, was included as an exceptional profit of £238 million in other operating income for that year.

Operating costs

Total operating costs increased by 7.7% in the 1999 financial year to £13,305 million after increasing by 4.7% in the 1998 financial year. As a percentage of group turnover, operating costs decreased from 79.0% in the 1997 and 1998 financial years to 78.5% in the 1999 financial year. In the 1999 financial year, exceptional costs of £69 million were incurred which primarily related to Concert expenses. These exceptional costs are considered separately in the table below and the discussion which follows.

	1999 £m	1998 £m	1997 £m
Staff costs	3,871	3,917	3,778
Own work capitalised	(428)	(424)	(399)
Depreciation	2,568	2,395	2,265
Payments to telecommunication operators	2,106	1,600	1,476
Other operating costs	5,119	4,867	4,676
Total operating costs before exceptional costs	13,236	12,355	11,796
Exceptional costs	69	-	-
Total operating costs	13,305	12,355	11,796

Staff costs for the 1998 financial year included a non-recurring charge of £120 million for compensation for the special dividend paid that year. The compensation was for those employees holding unexercised rights, mainly under group-wide sharesave schemes. Staff costs increased by 1.9% in the 1999 financial year, after rising by 0.5% in the 1998 financial year, if this non-recurring charge is excluded. In the 1999 financial year, the impact of pay awards was partially offset by reduced overtime worked and the reduction in average employee numbers. In the 1998 financial year, the pay awards impact was substantially offset by reduced pension costs, as explained in more detail below.

The allocation for the employee share ownership scheme, included within staff costs, was £64 million in the 1999 financial year, representing 2% of pre-tax profit for the year before the gain on the sale of MCI shares. The allocation in each of the 1998 and 1997 financial years was also £64 million.

The depreciation charge increased by 7.2% in the 1999 financial year to £2,568 million after increasing by 5.7% in the 1998 financial year, reflecting BT's continuing high level of investment in its networks.

Payments to other telecommunication operators grew by 31.6% in the 1999 financial year to £2,106 million after increasing by 8.4% in the 1998 financial year. The growth in these payments was primarily as a result of the growing number of calls terminating on UK competitors' fixed and mobile networks and, in particular, from the increase in mobile phone usage and Internet calls. The increase in the 1998 financial year was mitigated by lower payments to non-UK operators for outgoing calls from the UK as a consequence of lower prices and the strengthening of sterling more than offsetting call volume growth.

Other operating costs, which rose by 5.2% in the 1999 financial year to £5,119 million and by 4.1% in the 1998 financial year, include the maintenance and support of the networks, accommodation and marketing costs, the cost of sales of customer premises equipment and redundancy costs. The costs incurred in supporting the recent expansion of BT Cellnet was the main factor behind the increase in costs in the 1999 financial year. Also, in the 1999 financial year, a currency gain of £87 million from investing the proceeds of the MCI shares was offset against these costs. In the 1998 financial year, the cost increases were due to the expansion of BT Cellnet and Concert, and more was spent on BT's marketing programmes, including extensive TV advertising, than in the 1997 financial year.

Redundancy costs of £124 million were incurred in the 1999 financial year, compared with £106 million in the 1998 financial year and £367 million in the 1997 financial year. The lower costs in the 1998 and 1999 financial years compared with the 1997 financial year are a consequence of a surplus arising in BT's main pension scheme at its last full actuarial valuation at 31 December 1996. In view of this surplus, and in accordance with BT's accounting policies, redundancy charges for the 1999 and 1998 financial years do not include the costs of the incremental pension benefits provided to early retirees, which totalled £279 million and £224 million, respectively. In the 1997 financial year, redundancy costs included £258 million relating to incremental pension benefits.

Now that Concert is wholly owned by BT, work is being undertaken to ensure that the group's business becomes fully independent of MCI. The costs involved in this work are estimated at £150 million over the 1999 and 2000 financial years, of which £69 million had been incurred to 31 March 1999. These costs are shown as exceptional items in the group profit and loss account.

Group operating profit

Group operating profit for the 1999 financial year of £3,816 million was £159 million higher than in the previous year, which was £412 million higher than in the 1997 financial year. Before the exceptional income in the 1998 financial year and the exceptional costs in the 1999 financial year, described above, group operating profit in the 1999 financial year was 13.6% higher than in the 1998 financial year. This, in turn, was 5.4% higher than that in the 1997 financial year.

Associates and joint ventures

The group's share of its ventures' operating losses totalled £342 million in the 1999 financial year. The comparable losses, excluding MCI's results, amounted to £221 million in the 1998 financial year and £36 million in the 1997 financial year. The principal loss in all three years arose in Viag Interkom in developing its networks to compete in the German market; BT's share of these losses was £193 million, £151 million and £23 million in the 1999, 1998 and 1997 financial years, respectively. In the 1999 financial year, other losses were incurred by Telfort in the Netherlands, Albacom in Italy, British Interactive Broadcasting in the UK and LG Telecom in the Republic of Korea, which has been a BT joint venture since October 1998. In the 1998 financial year, the other losses were principally those incurred by Telfort and Cegetel in France, which has been a BT associate since September 1997.

As a consequence of the termination of the BT/MCI merger agreement and the then-prospective MCI/WorldCom merger, BT ceased treating MCI as an associate on 31 October 1997. The group's pre-tax profit for the 1998 financial year incorporated a loss of £27 million, representing BT's share of MCI's results up to that date, which included a special charge of £63 million. BT's share of MCI's pre-tax profit for the 1997 financial year amounted to £175 million, under BT's accounting policies.

Total operating profit

Total operating profit for the 1999 financial year at £3,474 million, including BT's share of the operating results of its ventures, increased by £13 million compared with the 1998 financial year after increasing by £32 million over the 1997 financial year. Before exceptional items, total operating profit for the 1999 financial year was 9.9% higher than that in the previous financial year, which was 6.0% lower than the result for the 1997 financial year, due principally to the losses in the group's new ventures.

Profit on sale of MCI shares

Following the completion of the MCI/WorldCom merger on 15 September 1998, BT sold its holding in MCI to WorldCom under the agreement made in November 1997. The proceeds totalled £4,159 million on which an exceptional profit of £1,133 million was realised in the 1999 financial year, after taking into account the goodwill written off on BT's interest in MCI, originally acquired in September 1994.

Interest charge and bond repurchase premium

In the 1999 financial year, the group's net interest charge at £286m was £24 million lower than in the preceding year. The group benefited since September 1998 from the interest derived from the short-term investments funded with the MCI share sale proceeds. In the 1998 financial year, the group's net interest charge of £310 million was £136 million higher than the interest charge in the previous year, due mainly to the increase in the group's net debt following the special dividend payment in September 1997. Interest cover for the 1999 financial year represented 12 times total 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 of these bonds was repaid on its maturity in March 1997.

Profit and taxation

The group's profit before taxation for the 1999 financial year was £4,295 million, compared with £3,214 million in the 1998 financial year and £3,203 million in the 1997 financial year. The higher profit in the 1999 financial year was due substantially to the gain on the MCI shares sold. Before this and other exceptional items, profit before taxation in the 1999 financial year was 9.4% higher than the comparable profit in the 1998 financial year. This was 7.1% below that in the 1997 financial year due to the initial impact of our ventures' losses in the 1998 financial year and higher interest charges following the special dividend payment.

The tax charge of £1,293 million for the 1999 financial year as a percentage of profit before taxation was 30.1%, compared with an ordinary tax charge of 30.4% for the 1998 financial year and 34.4% for the 1997 financial year. The group's tax charge for the 1999 financial year is an effective 31.0% of pre-tax profit, excluding the MCI share sale gain, which is effectively subject to a lower tax charge under UK capital gains tax legislation. The group's ordinary tax charge for the 1998 financial year was an effective 31.5% of pre-tax profit, excluding the MCI merger break-up fee which again was similarly subject to a lower tax charge. These effective tax charges reflect the lower 31% rate of corporation tax set for the 1999 and 1998 financial years, compared with 33% for the 1997 financial year. The higher effective rate in the 1997 financial year was due to the premium on the bond repurchase being only partially deductible for tax purposes. HM Government has set the corporation tax rate for the 2000 financial year at 30%.

The tax charge for the 1998 financial year included BT's £510 million share of HM Government's windfall tax on certain privatised companies, imposed in July 1997. The tax was paid in two equal £255 million instalments in December 1997 and December 1998.

Earnings and dividends

Basic earnings per share, based on a profit for the 1999 financial year of £2,983 million, were 46.3 pence. Earnings per share for the 1998 and 1997 financial years were 26.6 pence and 32.8 pence, respectively. Earnings before exceptional items were 34.7 pence per share for the 1999 financial year, in comparison with 31.7 pence for the 1998 financial year and 32.8 pence for the 1997 financial year. Diluted earnings per share are not materially different.

Dividends paid and recommended for the 1999 financial year of 20.4 pence per share represent a 7.4% increase on the previous year and are covered 1.7 times by earnings before exceptional items. These dividends comprise the interim dividend of 8.1 pence per share, paid in February 1999, and the proposed final dividend of 12.3 pence per share which, if approved at the annual general meeting, will be paid on 20 September 1999 to shareholders on the register on 20 August 1999. These dividends will absorb £1,322 million.

In the 1998 financial year, BT paid or recommended ordinary dividends of 19.0 pence per share. The company also paid a special dividend of 35.0 pence per share in respect of the 1997 financial year. This dividend, which was paid in September 1997, absorbed £2,244 million. For the 1997 financial year, ordinary dividends of 19.85 pence per share were paid or recommended. The Board adjusted the level of subsequent dividends to take into account the effect of the special dividend.

Financing

Net cash inflow from operating activities of £6,035 million in the 1999 financial year compared with £6,071 million in the 1998 financial year and £6,185 million in the 1997 financial year. The £200 million special contribution to the main pension fund, described below, reduced the cash inflow in the 1999 financial year. The higher net cash inflow in the 1997 financial year than in either of the two later years reflected a reduction in working capital in that year.

Tax paid in the 1999 financial year, which totalled £630 million, included the second and final windfall tax instalment of £255 million. We paid less UK corporation tax than in either of the two previous years because of the advance corporation tax (ACT) paid on the 1997 special dividend. In contrast, the tax paid in the 1998 financial year, which totalled £1,886 million, was particularly high because of £561 million ACT paid in respect of the special dividend and £255 million paid as the first windfall tax instalment. The tax paid in the 1997 financial year, which amounted to £1,045 million, principally related to the prior year's profit.

The UK Government has changed 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 over the 2000 to 2002 financial years, and replace the former main single corporation tax payment made nine months after the financial year end and ACT payments associated with dividends. The effect

	1999 £m	1998 £m	1997 £m
Net cash inflow from operating activities	6,035	6,071	6,185
Dividends from ventures	2	5	7
Net cash outflow for returns on investments and servicing of finance	(328)	(160)	(220)
Tax paid	(630)	(1,886)	(1,045)
Net cash inflow (outflow) for capital expenditure and financial investment	1,046	(3,108)	(2,820)
Net cash outflow for acquisitions and disposals	(1,967)	(1,501)	(252)
Equity dividends paid	(1,186)	(3,473)	(1,217)
Cash inflow (outflow) before management of liquid resources and financing	2,972	(4,052)	638
Management of liquid resources	(2,447)	2,247	(504)
Net cash inflow (outflow) from financing	(458)	1,794	(224)
Increase (decrease) in cash in the year	67	(11)	(90)
Decrease (increase) in net debt in the year	3,146	(3,860)	849

of these accelerated payment arrangements will be to increase the tax payments to be made by the group in the 2000 to 2002 financial years, notwithstanding the reduction in the standard rate of corporation tax to 30% for these years.

Net cash inflow of £1,046 million from capital expenditure and financial investment in the 1999 financial year mainly comprises the £4,159 million proceeds of the MCI shares sold in September 1998 offset by expenditure on plant, equipment and property totalling £3,220 million. This net cash inflow compares with outflows of £3,108 million in the 1998 financial year and £2,820 million in the 1997 financial year, which were principally for capital expenditure.

The net cash outflow on acquisitions totalled £1,967 million in the 1999 financial year, the principal part of which was the acquisition of MCI's minority interest in Concert, the investment in LG Telecom and Binariang as well as additional funding of the European ventures discussed below. The group's investment in Cegetel in September 1997 represented the main part of the net cash outflow of £1,501 million for the 1998 financial year.

Equity dividends paid in the 1999 financial year totalled £1,186 million. Those paid in the 1998 financial year amounted to £3,473 million and included the special dividend of £2,244 million in September 1997. In the 1997 financial year, dividends of £1,217 million were paid.

The resulting cash inflow, before liquid resources and financing, of £2,972 million in the 1999 financial year was mainly applied by investing in short-term investments. In the 1998 financial year, there was a resulting cash outflow of £4,052 million. This was financed by the issue of new loans, principally two Eurobonds totalling US\$2,500 million, and by using the group's existing short-term investments. In the 1997 financial year, the group had a positive net cash inflow before financing of £638 million.

The cash inflow for the 1999 financial year, generated mainly by the MCI share sale proceeds, resulted in net debt falling to £953 million at 31 March 1999. This was after the high cash outflow in the 1998 financial year caused by the special dividend payment and the investment in Cegetel which had resulted in net debt rising to £3,977 million at 31 March 1998. Consequently, balance sheet gearing or the ratio of net debt (borrowings net of cash and short-term investments) to shareholders' equity and minority interests stood at 6.3% at 31 March 1999, compared with 36% a year earlier.

In the 1999 financial year, the group repaid long-term debt totalling £457 million; no significant new long-term debt needed to be raised. In the 1998 financial year, the group borrowed £1,637 million in long-term loans and repaid £338 million in long-term debt. 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.

On 18 May 1999, BT issued a £600 million 5.75% Eurobond repayable in 2028. In the 2000 financial year, £575 million of long-term debt falls due. We expect to fund this by liquidating short-term investments or refinancing it with further debt, as appropriate.

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 treasury 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.

We have set out further details on this topic and on our capital resources and foreign currency exposure in note 33 to the financial statements in compliance with FRS13.

Capital resources

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 1999, the group had cash and short-term investments of £3,380 million. At that date, £372 million of short-term debt was outstanding. In addition, the group had unused committed short-term bank facilities, amounting to approximately £150 million at 31 March 1999, in support of a commercial paper programme or other borrowings. The group also has substantial uncommitted short-term bank facilities.

The group had £953 million net debt at 31 March 1999, a decrease of £3,024 million in the year. Net debt reduced substantially during the course of the 1999 financial year, primarily as a result of the MCI share sale.

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 1999, the group had outstanding interest rate swap agreements with notional principal amounts totalling £1,371 million.

Foreign currency and interest rate exposure

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 £1,880 million at 31 March 1999, are used to finance its operations. 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 and the euro. As a result of these policies, the group's exposure to foreign currency arises mainly on the residual currency exposure on non-UK investments and on any imbalances between the value of outgoing, transit and incoming international calls with non-UK 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, with the exception of the second half of the 1999 financial year when we had a large US dollar position with the short-term investments resulting from the MCI proceeds. We progressively closed out this exposure in the period to 31 March 1999 as the US dollar strengthened against sterling and, as noted above, we recorded a gain of £87 million, which has been included in the profit for the year.

The group is not significantly exposed to changes in interest rates. Based upon the composition of net debt at 31 March 1999, a one percentage point increase in interest rates would decrease the group's net interest expense by less than £35 million. The group is also not significantly exposed to changes in currency rates. A 10% strengthening in sterling against major currencies would cause the group's net assets at 31 March 1999 to fall by less than £250 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.

Capital expenditure

Capital expenditure on plant, equipment and property totalled £3,269 million in the 1999 financial year, compared with £3,030 million in the 1998 financial year and £2,719 million in the 1997 financial year. Work continues on enhancing the intelligence of the network to enable customers to benefit from advanced services and improving the network's capacity to carry high-speed data. BT Cellnet has continued improving the quality and capacity of its digital GSM network.

The group expects capital expenditure in the 2000 financial year to be at a level similar to, or slightly higher than, that of the 1999 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, associates and joint ventures

Following completion of the MCI/WorldCom merger in September 1998 and on the same day as the sale of the MCI shares, BT acquired from MCI its 24.9% interest in Concert for £607 million. Goodwill of £568 million arose on this transaction. This goodwill is not being amortised and Concert is to be transferred at a profit to the proposed global venture with AT&T once we obtain regulatory clearances.

In March 1999, the group, through its 60%-owned subsidiary BT Cellnet, completed the acquisition of Martin Dawes Telecommunications Holdings Limited (MDT), then the largest independent mobile telecommunication services provider in the UK. The consideration totalled approximately £130 million of which £90 million is deferred. Vodafone, a major supplier to the MDT group, continues to own 20% of MDT's main operating subsidiary, although it has, until September 1999, the right to sell its holding to BT Cellnet. Goodwill of £160 million arose on this acquisition and will be amortised over 10 years.

The group has invested £1,326 million in the 1999 financial year on acquiring interests in associates and joint ventures and providing their further funding. The most significant investments were made in October 1998 in the Asia-Pacific region. A 33.3% stake in Binariang of Malaysia was acquired for £279 million and a 23.5% interest in LG Telecom in the Republic of Korea was acquired for £234 million. The goodwill element of these acquisitions is being amortised over 20 years under the group's new accounting policy for goodwill adopted from the beginning of this financial year. BT continued to share in funding the development of its ventures, principally Viag Interkom of Germany (£482 million) and Telfort of the Netherlands (£103 million), in the financial year.

In the 1998 financial year, the group invested over £1,650 million in acquisitions and further funding. In September 1997, the group completed its acquisition of a 26% interest in Cegetel of France for a total of £1,029 million. Over £400 million was 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 was written off to reserves under the UK accounting policy in operation for that and preceding years.

In the 1997 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 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, BT Telecomunicaciones, 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.

In April 1999, we completed the acquisition of a 20% interest in ImpSat, a leading telecommunications company in Latin America for approximately £90 million. Also, in May 1999, we acquired a 20% interest in SmarTone of Hong Kong, a leading provider of digital mobile communications services, for approximately £240 million.

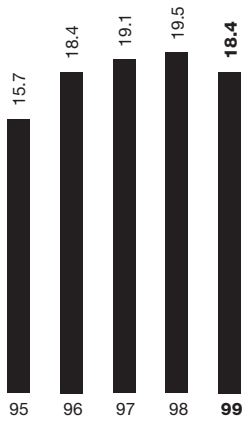
On 25 April 1999, BT, together with AT&T, announced that they would acquire a 30% interest in Japan Telecom. The consideration will be about £1.2 billion. BT will have an economic interest of 20% with both companies jointly managing the investment. BT Communication Services will be integrated into Japan Telecom. Subject to regulatory clearances, the transaction is expected to close by autumn 1999.

Global venture with AT&T

The proposed global venture with AT&T for our trans-border telecommunications activities will be jointly owned. We will be transferring to it the majority of our cross-border international networks, our international traffic, our business with selected multinational customers and our international products for business customers, as well as Concert. The formation of this venture is subject to regulatory clearances which we expect to obtain later in 1999. Following the formation of the global venture, total turnover, including our share of the ventures' turnover will increase, although group turnover, excluding this share, will reduce as a consequence of these activities being transferred.

Return on capital employed

% return on capital employed
YEARS ENDED 31 MARCH



The group made a return of 18.4% on the average capital employed in its business, on a historical cost basis, in the year ended 31 March 1999, compared with returns of 19.5% and 19.1% in the previous two financial years, respectively.

Pensions

The most recent actuarial valuation of BT's main pension fund was carried out as at 31 December 1996. This valuation revealed the fund to be in surplus to an amount of approximately £66 million. Assets of the fund at £19,879 million at that date covered just over 100% of the fund's liabilities, in contrast to an asset coverage of 97% at the previous valuation date, 31 December 1993. The actuarial valuation took into account the effect of HM Government's measures in July 1997 to end pension funds' ability to reclaim the tax credit associated with UK companies' dividends.

The group's annual pension charges for the 1999 and 1998 financial years of £176 million and £177 million, respectively, have been based on the December 1996 valuation. These charges compare with the charge of £291 million in the 1997 financial year which was based on the previous valuation. These lower charges take into account the amount of the pension provision which had been established over recent years in the group's accounts and which stood at £953 million at 31 March 1999. Additionally, under UK accounting standards, the cost of providing incremental pension benefits for early leavers in the 1998 and 1999 financial years has not been charged against the profit in the period in which people agree to leave, since the latest actuarial valuation of the pension fund indicated a surplus.

The actuarial valuation confirmed that the group's ordinary contribution into the fund should continue at 9.5% of employees' pensionable pay. The company paid a special contribution of £200 million into the fund in March 1999. This was made in part because the investment return on the fund's assets in 1998 fell slightly below the market average.

The number of retired members and other current beneficiaries in the pension fund has been increasing in recent years and, at 31 December 1998, was approximately 50% 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.

The next full actuarial valuation of the pension fund will be carried out as at 31 December 1999.

Impact of inflation

In accordance with a requirement of BT's main licence, the group's annual accounts for the 1998 financial year prepared on a current cost basis were published in September 1998. These accounts showed that the group's current cost profit before tax was £2,210 million, compared with £3,219 million under the historical cost convention. The group's current cost total assets at 31 March 1998 were £28,017 million, compared with £23,285 million in its historical cost accounts. The current cost accounts for the 1999 financial year are to be published by 30 September 1999.

Environment

When removing old analogue exchange equipment from buildings, BT recycles the metal content and takes special care to properly dispose of any hazardous materials. 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.

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 1999 and 1998 financial years, approximately 96% of the group's turnover was generated by operations in the UK, compared with 97% in the 1997 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 1998, 1997 and 1996 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 the 1999 financial year, BT has provided 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. This information is set out in note 35 to the financial statements. It should be appreciated that this information is used internally as part of the group's system of management and budgetary control over income and costs and the absolute results for any one particular element are not necessarily meaningful in isolation. In particular, capital resource allocation is planned and managed using capital project systems which are centralised in nature.

Tangible fixed assets

For the 2000 financial year, BT will be adopting FRS15 on tangible fixed assets. We do not foresee that the introduction of this new financial reporting standard will have any significant impact on our results.

Year 2000

The Year 2000 problem arises from the inability of many computer-based systems to handle correctly the century date change and other significant dates such as 29 February 2000. BT has recognised this issue for some time and, in December 1995, established a programme to tackle the problem. Working to guidelines defined by the British Standards Institution, we set out to deploy conformant systems, including those which support billing and finance, into our computer and telecommunications networks by 31 December 1998. We believe that we have substantially achieved this aim and, subject to the risks identified below, we plan to offer customers normal levels of service during the transition into the year 2000 and beyond.

The programme is now in its final phase where the focus is on the continuity of our business, including the completion of all outstanding technical work, maintaining conformance and regular, periodic reviews of our contingency plans to manage the risks of the Year 2000 transition.

BT is working closely with other UK operators, Oftel, the utilities and HM Government (including Action 2000, the Government-appointed body dealing with Year 2000) to ensure that not only is BT ready but also that its risks and dependencies are fully understood.

BT has about 650 corporate systems and about 97% were declared conformant by our target date of 31 December 1998. Our Year 2000 work incorporates supporting the conformance programmes of our joint ventures. However, progress on global services is complicated by the group's dependency on non-UK operators at the national and local level. BT is part of the International Telecommunications Union Taskforce to stimulate action through information sharing, workshops in high-risk regions, testing between operators and other initiatives with the UN, the EU and IMF. We believe much progress has been made around the world but concern exists for a minority of international operators where information is sparse.

The total cost of the Year 2000 programme is expected to be around £300 million, which is being funded by displacement of other activities. The cost includes BT's own people. We believe that costs will be held within this forecast as much of the spending had been completed by 31 March 1999. Costs to be incurred in the 2000 financial year are estimated at around £70 million. Depending on circumstances, there is likely to be increased demand for our network services and, hence, costs may vary.

All Year 2000 related investigation, remedial work and testing costs have been written off as incurred as these relate to making existing computer software Year 2000 conformant.

As the technical work is almost complete, the risk of an internal failure arising from a date-related problem has been reduced. We believe the greatest risks are external to the group and they include:

- the failure of parts of the services or systems of an international operator could result in loss of revenue if BT is unable to terminate a call or reconcile billing;
- potential congestion on the network. BT expects demand for telecommunications services to exceed its normal peak at the beginning of 2000 due to additional celebrations and resulting emergencies. Other

organisations may be testing their networks at the same time, placing additional demands on BT;

- many small failures, inside or outside BT, could occur simultaneously and multiply;
- failure in the supply chain causing stock shortages and disruption in the transport network;
- extreme bad weather at the turn of the year could add a further burden.

Contingency plans are in place to mitigate these risks. Contingency plans are built upon existing incident management and emergency plans but have been enhanced to include a transition operating plan to deal with the special needs of this particular new year. BT has invested in additional equipment to manage congestion and protect the 999 emergency service. Where there remains a risk, additional contingency plans are in place and a special remuneration package has been arranged for employees to ensure that key areas of the business are properly resourced over the New Year period. Contingency plans fall into three categories:

- prevention: plans in this category deal with changes from third party suppliers;
- mitigation: while we are unable to prevent unusual demand for our services, we are undertaking risk assessment on the likely demand and will then add network capacity where it is justified;
- transition: we believe the most probable risks will result from the combination of demand for services and event-related disruption rather than technical failure.

The activities of BT's Year 2000 programme focus on achieving a significant reduction of the Year 2000 risk. However, due to various unknowns, mainly relating to insufficient information regarding the readiness of non-UK carriers and other third parties, the effect of this issue on BT will not be known until January 2000. There can be no assurance or guarantee that the Year 2000 problem will not have a material adverse effect on our business, financial condition or results of BT's operations. A Year 2000 failure could result in BT being unable to continue to provide its services to its customers, loss of network capability, inaccurate billing, loss of revenue and reputation, legal and regulatory exposure and failure of management controls. BT believes, however, that its Year 2000 programme is reducing the level of uncertainty and, together with its continuity planning, will reduce the risks it faces.

The above disclosure is the Year 2000 readiness disclosure within the meaning of the US Year 2000 Information and

Readiness Disclosure Act of 1998 to the extent that the disclosure relates to Year 2000 processing by BT or products or services offered by BT.

Economic and Monetary Union (EMU)

On 1 January 1999, a new currency, the euro, was introduced into the European Union as part of EMU and 11 participating member states established fixed conversion rates between their existing currencies and the euro. The currencies of these participating member states now exist only as subdivisions of the euro.

Most of the group's business in Europe is conducted in the UK, which remains outside EMU. Government policy on UK membership of the single currency was set out by the Chancellor of the Exchequer in a statement to the House of Commons in October 1997. The determining factor underpinning any Government decision on membership of the single currency is whether the economic case for the UK joining is clear and unambiguous. Because of the magnitude of the decision, HM Government believes that, whenever the decision to enter is taken, it should be put to a referendum of the British people. In the National Changeover Plan published in February 1999 by HM Government, it was stated that, barring some fundamental and unforeseen change in economic circumstances, making a decision during this Parliament to join was not realistic but preparations should be made so that, should five economic tests set out by the Government be met, a decision to join a successful single currency can be made early in the next Parliament.

BT set up a steering group early in 1998 with representatives from across the group to review the impact of the introduction of EMU. A project team acts as a co-ordination point to ensure consistency of approach across the group and that plans are in place to meet agreed business strategy on EMU. BT is prepared to allow customers to settle certain sterling-based bills in euros under certain circumstances.

The group carries on business in certain of the participating member states and is taking appropriate steps to adapt its operations to use the euro.

BT is considering the impact of EMU on the UK business and the associated costs.

US GAAP

The group's net income and earnings per share for the three financial years ended 31 March 1999 and shareholders' equity at 31 March 1999 and 1998 under

US Generally Accepted Accounting Principles (US GAAP) are shown on page 98. 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. Cash flow information under the US GAAP presentation is also shown on page 99.

In its US GAAP reconciliation statement for the 2002 financial year, BT expects to adopt SFAS No. 133 on accounting for derivative instruments and hedging activities. Under this standard, derivative instruments are required to be included in the balance sheet at fair value and certain changes in these fair values need to be recognised in the income statement. We are in the process of assessing the impact of this statement on our US GAAP reconciliations.