

PART I

ITEM 1 – DESCRIPTION OF BUSINESS

Introduction

BT is one of the world's leading providers of telecommunication services. Its main services and products are local and national calls in the United Kingdom, the provision of exchange lines to homes and businesses, international calls made from and to the United Kingdom, the provision of private circuits to businesses, the supply of mobile communication services and equipment to businesses and individuals and the supply of telecommunication equipment for customers' premises. BT also offers a range of other products and services.

The company was incorporated under the laws of England and Wales on 1 April 1984 as a public limited company wholly owned by Her Majesty's Government of the United Kingdom ("HM Government"). In a series of three offers to the public, HM Government reduced its holding from 100% in December 1984 to less than 1% in July 1993. HM Government now has a residual holding of less than 0.2% of the outstanding Ordinary Shares.

Strategy

BT's strategy is to become the most successful worldwide telecommunications group by developing and growing new business in the United Kingdom, which BT believes has the most open and competitive telecommunications market in the world; to move into new growth markets such as mainland Europe; to serve the needs of multinational companies; and to expand into high growth services such as mobile, data, multimedia and the Internet.

Recent developments

Full liberalisation of telecommunications markets took effect throughout most of the European Union/European Economic Area from 1 January 1998. Liberalisation is generally being achieved through the enacting of legislation to remove barriers to competition. This includes the award of additional licences to operate fixed and mobile telecommunication services which will increase customer choice, the setting of rules to guarantee interconnection on non-discriminatory terms, and the establishment of independent regulatory authorities. It is backed up in a growing number of cases through the privatisation of state owned telecommunication companies. In several cases where European Union member states have failed to implement liberalisation measures correctly, the European Commission has initiated legal enforcement proceedings.

BT believes that it is well positioned to penetrate local markets in Europe following liberalisation and it works closely with regulatory and competition authorities to ensure the maximisation of competitive market conditions. It has entered into a number of alliances across Europe in order to gain presence in major European markets. See "Alliances and Joint Ventures – Overseas".

In 1994 BT acquired a 20% holding in MCI Communications Corporation ("MCI"), the second largest of the US long-distance telephone operators and formed with MCI a global joint venture, Concert Communications Company ("Concert Communications"), to pioneer global services and pool technical and marketing resources. See "Alliances and joint ventures – Overseas". On 3 November 1996, the Boards of Directors of BT and MCI announced that they had reached agreement for a merger of the two companies (the "Merger"). Following the announcement of reduced earnings expectations by MCI on 10 July 1997, BT and MCI conducted a joint management review into the prospects of both companies. On 22 August 1997, BT and MCI announced that they had agreed to new terms for the Merger which reflected changes in the marketplace. On 1 October 1997, WorldCom Inc ("WorldCom") announced its intention to offer shares in its company to MCI shareholders as an alternative to the BT/MCI merger. Following an improved offer from WorldCom on 9 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 was terminated. Under the terms of an agreement between BT, MCI and WorldCom (the "WorldCom agreement"), BT received \$465 million on 12 November 1997, as the break-up fee and partial reimbursement of expenses incurred on the BT/MCI merger agreement.

Under the terms of the WorldCom agreement, BT has agreed to sell its holding of 136 million Class A common shares in MCI to WorldCom for \$51 per share in cash at the time the MCI/WorldCom merger is completed. The transaction, which has been approved by MCI and WorldCom shareholders and is awaiting regulatory approvals in the United States and Europe, is expected to close in 1998. Also under the WorldCom agreement BT, which

owns 75.1% of Concert Communications, has agreed to acquire MCI's interest in Concert Communications at a price to be negotiated.

BT is committed to providing comprehensive sales, service and support for customers of Concert Communications. BT believes that there may still be investment opportunities in the US market and continues to consider all of its options.

Competition and regulatory environment

BT operates in the United Kingdom in an environment of growing competition and extensive regulation. The growing number of providers of telecommunication services is creating an increasingly competitive market for those services. The services that generate a majority of the group's operating revenues, or turnover, are currently regulated through a licence granted by the UK Secretary of State for Trade and Industry (the "Secretary of State") which is enforced by the UK Director General of Telecommunications (the "Director General"), who also has broad supervisory powers and duties under the UK Telecommunications Act 1984 (the "Telecommunications Act"). This licence has been amended frequently. See "Regulation, competition and prices". As BT expands its interests and activities outside the United Kingdom, regulatory regimes elsewhere in the world are becoming an increasingly important feature of its operating environment.

BT's services

The following table shows the principal components of BT's operating revenues during each of the last five fiscal, or financial, years. In the financial year ended 31 March 1998 (the "1998 financial year"), approximately 96% of BT's total turnover arose from operations in the United Kingdom.

Turnover	Year ended 31 March					1998 % of total
	1994	1995	1996 (in millions)	1997	1998	
UK local and national calls	£ 5,193	£ 4,941	£ 4,882	£ 4,874	£ 4,924	31
International calls	1,960	1,935	1,980	1,809	1,553	10
Exchange line rentals	2,402	2,534	2,685	2,811	2,957	19
Private circuits	992	1,024	1,056	1,124	1,149	7
Mobile communications	459	657	856	949	1,089	7
Customer premises equipment supply	1,003	1,041	946	914	896	6
Yellow Pages and other directories	343	371	408	438	466	3
Other sales and services	1,323	1,390	1,633	2,016	2,606	17
Total turnover	£13,675	£13,893	£14,446	£14,935	£15,640	100

BT essentially operates as a unitary business, providing an integrated range of telecommunication products and services. Management considers that the group's net operating income or operating profit, is derived predominantly from UK local and national and international calls.

UK fixed network

Within the United Kingdom, the company has more than 27 million customer lines (exchange line connections), comprising approximately 20.1 million residential lines and approximately 7.5 million business lines, over which, on average, approximately 100 million UK local and national calls are made each day. Calls comprise both voice and non-voice traffic, such as facsimile and data transmissions, and include calls to directory assistance services.

The following table shows the estimated growth rates in the volume of BT's UK local and national calls in each of the last five financial years:

BT's UK call growth	Year ended 31 March				
	1994	1995	1996	1997	1998
Estimated growth over previous year in BT's UK call volume (a)	6%	7%	6%	7%	7%

(a) Growth is estimated by reference to revenue growth attributable to UK local and national calls, adjusted to eliminate the effect of price changes.

UK local and national calls accounted for approximately 31% of the group's total turnover in the 1998 financial year.

Call growth in recent years has resulted mainly from the increase in usage of the lines in service, stimulated partly by significant price reductions introduced since December 1993 and partly by the growth in the UK economy.

The price structure for call charges varies with distance, duration, time of day, usage and the applicability of discount schemes. BT charges for the exact duration of the call, subject to a minimum charge.

In the 1998 financial year, exchange line rentals accounted for approximately 19% of the group's total turnover. BT's exchange line customers are generally charged a uniform quarterly rental per line, the charge for business lines being higher than for residential lines.

The following table shows, for BT's business and residential exchange lines, the number of connections at the end of each of the last five financial years and the respective percentage growth or decline in the number of connections from the previous year:

BT's exchange line connections	At 31 March				
	1994	1995	1996	1997	1998
(in thousands, except percentage amounts)					
Business	6,129	6,459	6,798	7,160	7,521
Growth	3.1%	5.4%	5.2%	5.3%	5.0%
Residential	20,471	20,613	20,500	20,393	20,130
Growth (decline)	1.8%	0.7%	(0.5)%	(0.5)%	(1.3)%
Total	26,600	27,072	27,298	27,553	27,651
Growth	2.1%	1.8%	0.8%	0.9%	0.4%

Since the beginning of 1995 BT has experienced a small net reduction in residential exchange line connections as a result of the growing competition from cable operators which offer integrated television and telephony services. See "Regulation, competition and prices – Competition – Cable operators" for a discussion of the growth of cable telephony.

BT also undertakes the installation and reconnection of exchange lines. Revenues from these services are included under "Other sales and services".

International calls

International calls accounted for approximately 10% of the group's total turnover in the 1998 financial year. In the 1998 financial year, the greater part of BT's international call traffic was generated from a limited number of routes and 73% of outgoing call volume was to 15 countries. The United Kingdom is one of the world's principal telecommunication transit centres, enabling calls originating and terminating outside the United Kingdom to be routed through it. International direct dialling from BT's UK network is available to more than 230 countries and other territories, and almost all international calls originating from BT's UK network are direct dialled.

International call revenues are derived from outgoing calls made by customers in the United Kingdom and from receipts from overseas telecommunications operators for incoming calls which use BT's facilities. In turn, BT makes payments to overseas operators for the use of their facilities primarily for terminating calls. The rates for

payments (known as “accounting rates”) are agreed bilaterally under the general auspices of the International Telecommunications Union. BT’s receipts and payments are broadly in balance overall.

The following table shows the estimated growth rates in the volume of BT’s international calls (outgoing, incoming and transit) in each of the last five financial years:

BT’s international call growth	Year ended 31 March				1998
	1994	1995	1996	1997	
Estimated growth over previous year in BT’s international call volume (a)	6%	5%	9%	7%	9%

(a) Growth is estimated by reference to revenue growth attributable to international calls, adjusted to eliminate the effect of changes in prices and in currency exchange rates.

Growth in the volume of international calls over this period has resulted primarily from the increase in the usage of the lines in service. BT believes that the increased usage was partly attributable to significant price reductions.

BT continues to seek reductions in accounting rate levels, which historically have not generally kept pace with reductions in the underlying costs of providing international service other than on the more liberalised routes. However increasing liberalisation, competition and globalisation of the market place – underscored by the World Trade Organisation (“WTO”) agreement on basic telecommunications ratified on 5 February 1998 – is placing increased pressure for rates to be reduced to reflect more closely costs of service, continuing the downward trend in prices. BT expects that accounting rates will start to be replaced by more cost based arrangements. Lower rates increase BT’s flexibility in pricing international calls.

Volume changes for the activities described below have been estimated by adjusting revenues to eliminate the effect of price changes.

Private circuits

BT provides customers with private circuits, which are lines between fixed points reserved for the exclusive use of a customer, leased at a fixed rate irrespective of usage. There is continuing change from analogue to digital circuits, in part because digital circuits normally have a greater capacity and flexibility of use. Private circuit revenue volumes increased by approximately 5% in the 1998 financial year. Private circuit revenues accounted for approximately 7% of the group’s total turnover in the 1998 financial year.

Mobile communications

Mobile communication services and products supplied by BT mainly comprise cellular telephony, radiopaging and voice messaging and accounted for approximately 7% of the group’s total turnover in the 1998 financial year. Cellular telephony has continued to grow at a faster pace than other sectors of the telecommunications industry in the United Kingdom and internationally.

The company owns 60% of Cellnet, one of four cellular telephone network operators licensed by HM Government. Cellnet and Vodafone each provide digital and analogue communications networks while Orange and One 2 One provide digital personal communications networks (“PCN”). As a result of the rapid growth of PCN services, the market for mobile services is highly competitive with consequent pressure on prices and Cellnet continues to reduce a number of its charges.

In March 1998, the Director General referred BT, Cellnet and Vodafone to the UK Monopolies and Mergers Commission (the “MMC”) for investigation into BT’s retail charges for calls made from BT’s fixed network to Cellnet and Vodafone’s networks and Cellnet and Vodafone’s charges to BT for terminating such calls. The MMC is expected to report in autumn 1998. BT believes that the impact of the investigation is not likely to be significant to the group’s financial position and results of operations in view of the continuing reduction in prices. See “Regulation, competition and prices – Competition – Mobile services”.

Cellnet provides comprehensive coverage for virtually all of the United Kingdom population. It has operated a digital GSM service since 1994 alongside its analogue system, and approximately 75% of Cellnet’s users are now connected to the digital service. A substantial number of customers have migrated or are migrating from the analogue system to the digital system.

The digital service provides a technology platform for advanced high quality service offerings, including international roaming to 77 countries and across more than 120 networks to date, with the prospect of allowing much larger customer bases to be supported.

The following table shows the number of telephones connected to Cellnet's network at the end of each of the last five financial years:

Cellnet (Cellular telephones in the United Kingdom)	Year ended 31 March				1998
	1994	1995	1996 (in thousands)	1997	
Digital GSM	–	34	353	1,125	2,303
Analogue	1,019	1,700	2,036	1,573	774
Total	1,019	1,734	2,389	2,698	3,077

BT estimates that the total number of mobile telephones connected to the Cellnet and Vodafone networks at 31 March 1998 was 3.1 million and 3.4 million respectively, up from 2.7 million and 2.9 million respectively at 31 March 1997. In addition, Orange had around 1.3 million customers and One 2 One had around 1.2 million customers at 31 March 1998, up from 0.9 million and 0.6 million at 31 March 1997.

Changes were made during the 1998 financial year so that Cellnet now deals direct with the majority of its customers, rather than through service providers. Cellnet now has end-to-end contact with the majority of its customers with the benefits that direct communication will bring. Cellnet also acquired a 40% interest in The Link, part of the Dixons Group plc, in May 1997. The Link is a chain of 123 retail outlets which specialises in providing a complete range of telecommunications products and services.

New radio interface standards are being developed internationally for third generation mobile. Third generation mobile will provide greater bandwidth than current GSM technology for high speed data and multimedia applications to be used whilst on the move. HM Government is expected to auction licences for spectrum for third generation mobile in 1999 with commercial service likely to be available from 2000 onwards. BT expects the group to participate in the auction process.

Customer premises equipment supply

BT sells and rents a wide range of equipment for customer premises, from telephones for use in the home to advanced private exchange equipment for businesses. These activities accounted for approximately 6% of the group's total turnover in the 1998 financial year.

Yellow Pages

Yellow Pages is responsible for a portfolio of products including a series of regional classified information directories in the United Kingdom to meet both consumer and business needs. Sales of its products accounted for approximately 3% of the group's total turnover in the 1998 financial year. Revenue from volume growth of advertisements published by Yellow Pages increased by approximately 5% in the 1998 financial year compared with the 1997 financial year.

Other sales and services

Other sales and services, which accounted for approximately 17% of the group's total turnover in the 1998 financial year, include Syncordia Solutions in the UK and overseas, carrier telecommunication services, charges for exchange line connections, systems integration products and services, advanced services, audio-conferencing, and various other activities.

Syncordia Solutions – the end-to-end provision, maintenance and billing of value-added voice and data services. These services are brought to the international market by Concert Communications. Syncordia Solutions also supplies telecommunication outsourcing services for the management of complex international communication needs of organisations for voice and data.

Carrier telecommunication services – whereby existing telecommunications operators and new entrants to the UK telecommunications market can utilise BT's network through interconnection to it.

Systems integration – the business of enabling business change, by offering a combination of skills and technologies, and the underlying network and service platforms, through Syntegra, BT's systems integration business.

Advanced services – BT provides advanced voice services primarily through the FeatureNet service. BT also provides advanced services for data.

Other services – BT also provides freephone services, visual communication services, including the distribution of television material for broadcasting organisations, video-conferencing, closed circuit television and internet services.

Alliances and joint ventures

Overseas

In pursuing its international objectives, BT's approach has focused on providing network-based services to multinational and major national businesses primarily in North America, Europe, and the Asia Pacific region. In particular, this has been achieved through Concert Communications, BT's joint venture with MCI. There are partnerships in many countries with distribution agreements for Concert Communications' services in major business centres worldwide.

BT's relationship with MCI – in 1994, BT established a major alliance with MCI, the second largest carrier of long-distance telecommunications services in the United States. This involved the creation of Concert Communications which enabled BT and MCI to combine their international enhanced voice and data service. At about the time of the creation of Concert Communications, BT invested approximately \$4.3 billion (£2.8 billion) to acquire a 20% interest in MCI. BT currently has approximately 19% of MCI's share capital, pending closing of the WorldCom agreement. See "Recent developments". Mr Bert C Roberts, Jr., the chairman of MCI, and Mr Gerald H. Taylor, the chief executive officer of MCI, served as directors of the company during part of the 1998 financial year until they retired as directors of the company on 17 March 1998 and 9 November 1997, respectively.

Concert Communications – Concert Communications provides BT with a portfolio of globally managed voice and data related products and services. These services include packet services, frame relay, managed bandwidth and a full array of virtual voice network services and are provided across a global platform. Concert Communications' portfolio of products and services is targeted at meeting the international telecommunications requirements of multinational companies. It has achieved a leading position in the provision of international enhanced voice and data services. Concert Communications has approximately 3,800 corporate customers in more than 50 countries and has committed future revenues of almost \$1 billion per annum. Concert Communications is currently held 75.1% by BT and 24.9% by MCI. Under the WorldCom Agreement, BT has agreed to acquire MCI's interest in Concert Communications at a price to be negotiated, after which MCI will distribute Concert services in the United States on a non-exclusive basis for a limited period of time.

Europe – BT believes that it is well positioned to penetrate local markets in Europe following the liberalisation of the telecommunications market throughout most of the European Union on 1 January 1998. BT's alliance partners in Europe include: Viag and Telenor in Germany; Banca Nazionale del Lavoro, Mediaset and ENI in Italy; Vivendi (formerly Compagnie Generale des Eaux), Mannesmann and SBC in France; Nederlandse Spoorwegen (the Dutch state railway) in the Netherlands; Telenor and TeleDanmark in Sweden; TeleDanmark, Swiss Railways, Migros and UBS in Switzerland; and the Electricity Supply Board in the Republic of Ireland.

In September 1997, BT completed a transaction to take a 26% interest in Cegetel, a new French telecommunications group. Cegetel's fixed network services in France were launched at the beginning of February 1998. It holds a majority interest in SFR, the number two mobile operator in France. Viag Interkom, BT's German joint venture, was awarded a licence to offer fixed line services from 1 January 1998 and also has a mobile licence. In February 1998, Telfort, BT's joint venture in the Netherlands, was awarded one of the two new national Dutch mobile licences in addition to the fixed line licence it already held. Albacom, BT's Italian joint venture in which it has an economic interest of 23%, offers telecommunications services in the liberalised Italian market and has a fixed licence. Airtel, the Spanish mobile operator in which BT has a 16% interest, has more than one million mobile customers and approximately 40% of the Spanish digital mobile market.

Asia Pacific – BT-NIS, a Japanese joint venture between BT, Marubeni Corporation and others, in which BT owns 51%, began trading as a Concert distributor, Internet service provider and supplier of advanced voice

and data services in April 1997. In March 1997 BT acquired 22.5% of Bharti Cellular Limited, one of two cellular operators in Delhi, India. In April 1998 BT, in a consortium comprising Singapore Technologies Telemedia, Singapore Power and NTT of Japan, was awarded both a fixed and a mobile telecommunications licence in Singapore.

UK

In May 1997, BT announced the proposed formation of an independent company, British Interactive Broadcasting (“BIB”), with British Sky Broadcasting Group, Midland Bank and Matsushita, to deliver digital interactive services to television viewers in the United Kingdom. BIB will enable businesses to offer interactive services, including home shopping, banking, travel, educational, and public information services. In addition, through their televisions, customers will be able to connect to an E-Mail service. These services will be available through an ordinary telephone line connected to a digital satellite set top box that gives access to digital satellite television broadcasts. As part of the regulatory approvals process, which is still ongoing, BT has proposed to divest itself of its existing broadband cable television interests which are not core to the company’s strategy and which are insignificant to the group’s financial position and results of operations.

Network modernisation and capital expenditure

BT has been engaged in an extensive programme of modernising, improving and expanding its telecommunication network. BT completed the replacement of its semi-electronic exchanges in March 1998. The replacement of electro-mechanical exchanges was completed in June 1995. The installation of digital switching and associated transmission equipment throughout BT’s UK long-distance network was completed in 1991. BT is also continuing to install optical fibre cable in the network.

BT’s digital network has improved call quality for customers and provided management with more flexibility and control, and has led to reductions in maintenance manhours. It also makes possible the integration of voice, data and other services into a single Integrated Services Digital Network (“ISDN”).

Capital expenditure

BT’s capital expenditure over the last five financial years is shown in the table below:

BT’s capital expenditure	Year ended 31 March				
	1994	1995	1996	1997	1998
	(in millions)				
Plant and equipment					
Transmission equipment	£ 896	£1,060	£1,114	£1,131	£1,219
Exchange equipment	493	605	566	445	512
Other network equipment	335	378	491	503	502
Computers and office equipment	219	343	333	350	372
Motor vehicles and other	153	214	195	175	230
Property	51	75	87	143	211
Increase (decrease) in engineering stores	24	(4)	(15)	(28)	(16)
Total expenditure on property, plant and equipment	£2,171	£2,671	£2,771	£2,719	£3,030

The group’s expenditure on transmission equipment, exchange and other network equipment accounted for 74% of the total capital expenditure in the 1998 financial year. In that year there was 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. In addition, Cellnet continued expanding its digital cellular GSM network.

UK network

As a result of the programme of local exchange modernisation in the United Kingdom, 100% of the customer lines in service are now served by digital exchanges. The following table shows the percentage of customer lines in service served by type of exchange at the end of each of the last five financial years:

Network modernisation	At 31 March				
	1994	1995	1996	1997	1998
Customer lines served by type of telephone exchange					
Digital	74.9%	82.7%	87.7%	92.6%	100.0%
Semi-electronic	24.6	17.2	12.3	7.4	–
Electro-mechanical	0.5	0.1	–	–	–
Total	100.0%	100.0%	100.0%	100.0%	100.0%

This programme of modernisation enables BT to provide virtually all its customers with a range of network services, including call forwarding and reminder calls, the “call minder” service, providing call answering and routing services, and the call return service.

Optical fibre accounts for approximately 93% of the current capacity of BT’s UK national network. In the junction network (connecting local exchanges), optical fibre generally continues to be the most cost-effective method of meeting new capacity requirements. BT also continues to improve and modernise its local network of cables with approximately 60,000 business customer sites served by optical fibre cable.

The following table shows the number of kilometres of optical fibre in BT’s network at the end of each of the last five financial years:

Optical fibre	At 31 March				
	1994	1995	1996	1997	1998
Fibre – kilometres in the network	2,577	2,782	3,043	3,302	3,591

International networks

BT continues to invest in its international digital cable and satellite network infrastructure to support a growing range of advanced communication services between the United Kingdom and the rest of the world. Optical fibre cable links are now available from the United Kingdom to many destinations, including continental Europe. 75% of international public switched call traffic is routed via fibre cable. BT has investments in a number of international consortia which provide and own satellite communication facilities. All of BT’s international telephone calls are switched through digital international exchanges in the United Kingdom.

Research and development

Research and development is a primary mechanism by which BT aims to remain competitive. The major part of BT’s expenditure on research and development, which in the 1998 financial year totalled £307 million, is directed towards the development of new and improved networks and services for customers. Increasingly, resources are being devoted to software systems to provide better managed and more intelligent networks and network services, but work also continues on optical fibre systems, speech and image processing, mobile applications, data, Internet and interactive services.

Continuing development of products and services such as call centres, computer/telephony integration and corporate intranets, feature in BT’s research programme. Also under research are broadband applications, access network evolution, data services, customer handling systems, public warning systems, service management, electronic commerce, user authentication, multimedia services, advanced mobile terminals, healthcare services and education applications.

Organisation and employees

Organisation

BT is currently organised into two main operations, BTUK and BT Global; and a number of support units in the group's headquarters which provide specialised services. BTUK comprises three divisions, Business Division, Consumer Division and Networks & Systems.

Business customers whose telecommunications requirements fall mainly within the United Kingdom are served by Business Division. Consumer Division provides the primary interface between BT and its residential customers. It also has responsibility for BT's public payphones. Networks & Systems is responsible for the design, operation, maintenance and development of BT's networks and technology. It is also responsible for BT's research and development facility. BT Global serves business customers who require telecommunications services around the world and it is responsible for BT's relationship with joint ventures.

Employees

The following table shows the total number of BT's employees at the end of each of the last five financial years:

	At 31 March				
BT's employees	1994	1995	1996	1997	1998
Number of employees in the group:					
UK	153,900	134,900	127,800	123,300	120,200
International	2,100	2,600	2,900	4,200	4,500
Total employees	156,000	137,500	130,700	127,500	124,700

The number of BT's employees has fallen substantially since 1991 as a result of improvements in operating efficiency, a reduction in layers of management and in directory assistance work, the contracting-out of certain services, and business disposals. At the same time, BT has increased its use of temporary contract personnel, where this has been cost effective, to provide the particular skills and flexibility necessary to meet new and changing workloads in both field engineering and support services. BT expects this trend to continue where it is appropriate in the context of its overall resourcing strategy and the maintenance of positive industrial relations.

An estimated 80% of the company's employees belong to two main trade unions recognised by the company. The pattern of industrial relations in the last few years has been generally stable. The reduction in the number of employees has so far been implemented on a voluntary basis and without significant disruption to BT or its customers. BT completed the last of the company-wide voluntary workforce reduction programmes at the end of September 1996. These have been replaced with smaller, localised or business focused reduction programmes. In line with its continuing drive to improve productivity BT made further reductions in the 1998 financial year and such reductions are expected to continue.

Most BT employees are members of the BT Pension Scheme, which is controlled by trustees who are company or union nominees.

Regulation, competition and prices

Regulation

UK Regulation

The regime for the regulation of telecommunications activities in the United Kingdom is principally set out in the Telecommunications Act, which confers regulatory functions on the Secretary of State and the Director General. Under this Act, the Secretary of State and the Director General have a duty to exercise their functions to secure the provision, so far as reasonably practicable, throughout the United Kingdom of telecommunication services which satisfy all reasonable demands for them, including certain community services, and to secure the ability of licensed operators to finance the provision of those services. Subject to this duty, they are required, among other things, to promote the interests of consumers, purchasers and other users in respect of prices, variety and quality of telecommunication services and equipment, to maintain and promote effective competition between persons engaged in commercial activities in the UK telecommunications field and to promote efficiency and economy on

the part of such persons. These duties are under review in HM Government's review of utility regulation. See "HM Government's review of utility regulation".

With limited exceptions, a licence under the Telecommunications Act is required for the running of a telecommunication system in the United Kingdom. Responsibility for licensing rests with the Secretary of State after consulting the Director General. The Director General has broad supervisory powers and duties under the Telecommunications Act and licences issued under it. An important factor in the impact on BT of the UK regulatory system is how the Director General and the Secretary of State exercise their powers (many of which allow considerable discretion) and perform their duties.

The Director General is statutorily responsible for enforcing licence conditions, and he may make orders requiring compliance, enforceable in the UK courts, which, if breached, could result in liability for damages to third parties. He also has broad discretionary powers (under the Telecommunications Act and in licences) available to him and is responsible for monitoring the telecommunications market and investigating complaints about telecommunications related matters.

In addition, the Director General may modify licence conditions with the licensee's agreement. Alternatively, he may refer a matter concerning a licence to the MMC. If the MMC recommends modifying conditions of the licence concerned, the Director General is required to make the modifications which he considers necessary to remedy the adverse effects on the public interest identified by the MMC. In either case, the Telecommunications Act requires public consultation before licence condition modifications can be made. Licences may also be modified by legislation including the transposition into UK domestic law of European Union ("EU") directives. HM Government is currently undertaking public consultation on proposals to change the licence modification procedure to remove the need for an MMC reference where only a small percentage of licensees affected by a modification objected to its introduction.

The Director General has concurrent jurisdiction with the Director General of the UK Office of Fair Trading ("OFT") in exercising certain functions under the UK Fair Trading Act 1973 and under the UK Competition Act 1980, but only in so far as they relate to telecommunications. See "General competition law".

A new Competition Bill is currently being considered in the UK Parliament. See "General competition law".

The current Director General is David Edmonds. He was appointed effective 1 April 1998 and his current appointment continues until 31 March 2001. The Director General is supported by the UK Office of Telecommunications ("OfTel"), which has a permanent staff of about 170. The previous Director General was Donald Cruickshank who held office from 1 April 1993 until 31 March 1998.

HM Government's review of utility regulation

HM Government has initiated a review of utility regulation which is still in its early stages. Public responses to the consultative document were submitted to HM Government at the end of May 1998. HM Government has made a number of proposals for regulatory reform which include a tiered regime with little or no regulation for fully competitive industries, ranging to more close regulation for those industries where competition has not developed sufficiently. In its response, BT took the opportunity to show that, in the company's view, the development of competition in the telecommunications market means that the need for a special telecommunications regulatory regime is rapidly diminishing and that issues such as fair trading should now be overseen by the UK's general competition authorities, such as the MMC and the OFT.

The BT Licence

BT operates in the United Kingdom under a number of licences granted under the Telecommunications Act, the most important of which is its public telecommunications operator licence to operate its fixed-linked public telecommunication network (the "Licence"). The Licence is for a period of 25 years from 5 August 1984 and is revocable by ten years' notice (not to be given before 22 June 1999) and may also be revoked at any time on various grounds, including non-compliance with an enforcement order after notice.

The Licence contains terms and conditions designed principally to ensure the provision in the United Kingdom of widespread telecommunication services, to protect the interest of consumers and to encourage the development of effective competition in telecommunication services and equipment within the United Kingdom.

The company is required by the Licence to provide, throughout nearly all of the United Kingdom, telecommunication services, including rural and international services, which satisfy all reasonable demands to the extent that it is practicable to provide such services (the "universal service obligation"). The company must also provide certain public services and facilities.

The company is required to connect to its system on standard terms and conditions any other system run under a licence which authorises connection to the company's system and which is composed of equipment which meets specified independent approval standards and to install separate wiring for its network and for customers' equipment in customers' premises, so as to enable private systems and equipment to be separate from the company's system.

The company must comply with a variety of fair trading obligations, such as a prohibition on showing undue preference or discrimination in the provision of certain services or unfairly favouring any part of its own business as against competitors; a prohibition on the unfair cross-subsidy of certain businesses of the company; and a general prohibition on anti-competitive acts or omissions, in particular, agreements or concerted practices which may restrict or distort competition and abuse of a dominant position.

The Licence contains price control formulae, the overall effect of which requires the company to reduce, or restrict the extent to which it can increase, the prices of many of its services. See "Prices". In addition, the Licence contains certain specific restrictions on the terms on which BT can trade. In particular, the company is required to publish and adhere to standard prices and other terms for providing certain services and, in general, to apply uniformly a published scale of charges for installing residential exchange lines on premises to be served by a single line.

The Licence also contains provisions enabling the Director General to monitor the company's activities, including requirements for BT to supply him with information he requests and to maintain segregated accounting records for specified parts of its business. These parts, designated in the Licence for regulatory purposes, include the "systems business" (the activities of running the main UK network, including installation, maintenance and repair of the network and conveyance of telephone calls and other messages); the "supplemental services business" (generally value-added services and data services, including video-conferencing); and the "apparatus supply business" (broadly, the supply of customer premises equipment). In addition, the Licence requires the provision to the Director General and publishing of financial statements in respect of the systems business and apparatus supply business. In part, these financial statements are required to enable the Director General to satisfy himself as to compliance with the prohibition on unfair cross-subsidy discussed above. Where it appears to the Director General that an unfair cross-subsidy exists in relation to specified parts of its business, BT must take such steps as the Director General may direct to remedy the situation.

Domestic obligations in a global market

A new licence condition was introduced into BT's Licence in October 1997 prohibiting BT from doing anything by act or omission, that would detract materially from its ability during the remainder of the initial 25 year period of the Licence (see "The BT Licence") to meet its licence obligations to provide telecommunication services and any legal obligation to provide such services to a specified standard. BT's directors will be required to submit an annual compliance certificate to the Director General. The Director General may also, not more than once every 12 months, require BT to procure an auditors' report stating whether, in the auditors' opinion, BT has in place and has followed the appropriate systems and processes to enable the directors to form a reasonable opinion as to whether BT is complying with the obligation. The need for compliance certification and the option of an audit report will apply from 1 April 1998 to June 2004, unless extended.

Interconnection under the Licence

The company must, in accordance with the Licence, permit the interconnection to its system of certain other systems appropriately licensed for the provision of telecommunication services to the public. Prices of interconnection services prior to 1 October 1997 were determined by the Director General. This has been replaced by a network charge control regime running from 1 October 1997 to 30 September 2001 which gives BT the freedom to set charges for its standard interconnection charges. See "Prices – Network charge control." BT is required to publish an interconnection agreement, or an amendment of one, within 28 days of entering into or amending it and to provide a copy to any person who requests it.

Competition and Service (Utilities) Act 1992

Under the UK Competition and Service (Utilities) Act 1992, the Director General has powers concerning, among other things, service standards and the amount of compensation to be paid to individual customers if such standards are not met; overall performance standards; procedures for handling complaints; and criteria for charging deposits. The Director General's powers apply to BT in relation to a specified range of services, including voice telephony, facsimile and directory information services. In particular, he can set enforceable

performance standards after consultation with BT, but without the agreement of BT and without reference to the MMC. During 1995 the telecommunications industry voluntarily agreed to, and began publication of, comparable performance indicators. To date the Director General has not exercised such powers.

The Secretary of State is also empowered under this Act to make regulations giving the Director General power to resolve billing disputes.

As required by this Act, BT's complaints handling procedures, deposit guidelines and a procedure for resolving disputes about deposits have been formally approved. It is not expected that any other powers contained in this Act will be used in the near future. However, they will remain available and their effect cannot be assessed unless and until they are exercised from time to time. Although this Act contains powers which BT believes may, if implemented, have adverse effects on it, BT does not expect them to be material.

Universal service

In July 1997, the Director General published a statement setting out the result of his review of the universal service obligations of UK telecommunications operators. The company's unique obligations to provide service are to remain broadly unchanged but it is required to provide a new outgoing calls barred service at a low price targeted at the poorer sections of the UK community. This new service, which was introduced nationally in March 1998, is not expected to have a significant impact on revenues. The Director General will consider in 1999 whether to establish a universal service fund.

Radio spectrum licences

The use of radio spectrum in the United Kingdom is regulated under the Wireless Telegraphy Acts of 1949, 1963 and 1998. BT's national and international telecommunication networks, including microwave and satellite links, are dependent on licences under the 1949 Act. A comprehensive licence covers most of the company's existing fixed terrestrial and satellite links and the use of maritime radio frequencies. In 1996 the company was granted a separate licence under the Wireless Telegraphy Acts to authorise the use of spectrum for fixed telephony access in remote rural areas (covering about 4% of the UK population). Radiopaging services and Cellnet's cellular network are both licensed separately. Under the Act, wireless telegraphy licences can be revoked or varied at any time, by the Secretary of State.

Historically, the Secretary of State has delegated exclusive management control of some blocks of radio spectrum to BT. However, in 1991, HM Government stated that ultimately BT would lose management control of all its blocks with some specific exceptions. This is now happening at an increasing rate. Additionally, it is HM Government policy that well established networks should, where possible, move from radio to cable links.

The 1998 Act allows for charging for radio spectrum, including the use of auctions. BT expects that its operating expenses will increase in consequence if charges are introduced for use of the spectrum. It also expects that the speed and flexibility with which it currently provides new or modified radio links, both within its network and direct to customers, will be reduced, as self managed bands are taken back into Government management.

Overseas regulation

In developing its business internationally, BT must take account of the regulatory regimes in the countries in which it operates or wishes to operate.

In the United States, the FCC has extensive authority to regulate interstate services and local access facilities and services provided by common carriers, including the right to review the interstate rates charged by common carriers, as well as the authority to implement policies that promote competition for all telecommunication services.

The European Commission has been pursuing a policy of progressive liberalisation and harmonisation in telecommunications. Since 1 January 1998, the provision of infrastructure and all telecommunication services has been liberalised in the EU, apart from some derogations for the less developed member states. Also on 1 January 1998, new rules were put in place in respect of regulatory issues, including interconnections, universal service, transparent accounting and licensing. These are currently being transposed into national regulation and it is too early to assess what their impact on the company will be.

From 1 January 2000, the EU will require the availability of both carrier pre-selection, from operators with significant market power, and number portability at a fixed location between all fixed network operators.

BT has authorisations, either in its own right or through subsidiaries or joint venture companies, to provide services in a number of overseas countries, including the US. BT is also active in pressing for liberalisation of markets around the world to enable it to provide services to customers on a global basis. The agreement on basic telecommunications reached by the WTO in February 1997 and covering most of the world's major national markets is expected to lead to an acceleration of the liberalisation process and to increased opportunities for BT.

General competition law

In addition to regulation relating to BT or to the telecommunications industry in general, BT is subject to competition law of general application.

A bill is currently being considered by the UK Parliament that would amend UK competition law and bring it generally into line with European Union law, and in particular Articles 85 and 86 of the Treaty of Rome (i.e. the EU Treaty, which is the legal basis of the European Union conferring rights which can be upheld by national courts and by the European Court of Justice. Articles 85 and 86 are anti-competitive behaviour measures, prohibiting anti-competitive agreements/concerted practices and abuse of dominant market position). It would introduce general prohibitions in respect of (a) agreements which prevent, restrict or distort competition and (b) abuse of a dominant position by any undertaking. Enforcement will be by the Director General of Fair Trading and, in the case of telecommunications, the Director General of Telecommunications will have concurrent jurisdiction with the Director General of Fair Trading. This legislation would replace the fair trading licence condition currently existing in most public telecommunications operators' licences. Breach of the prohibitions could lead to fines of up to 10% of turnover and/or result in claims for damages in the civil courts. There are powers to order a company to cease an infringing activity. The bill would also introduce an independent appeals mechanism. If passed, the legislation is likely to come into effect during 1998 and 1999.

Under its powers to investigate potential infringements of the EU's competition rules, the European Commission is examining the arrangements of operators within the EU governing prices and accounting rates for international telephone calls. BT has responded to a fact-finding letter from the European Commission on this subject. The Commission's investigations are continuing.

Competition

The Conservative Party, which formed HM Government from 1979 and continued to be the governing party until 1 May 1997, followed a long-term policy from 1981 of seeking to introduce competition into the building and operation of public telecommunication networks in the United Kingdom, the provision of services over those networks, and the supply of equipment for connection to those networks. Entry to the market for the supply of telecommunications equipment is unrestricted and the supply of equipment to customers is highly competitive.

Direct competition was introduced in 1983 when Mercury, a subsidiary of Cable & Wireless plc, commenced initial services. BT faced competition since 1986 from Mercury in the provision of switched voice telephony and data services, particularly serving business customers. Mercury competed particularly in the provision to call intensive customers of international and long-distance calls, the most profitable parts of the UK telecommunications market.

The duopoly policy allowed only BT and Mercury to provide national fixed-link telecommunication services to the public. After the review of that policy in 1991, HM Government has followed a policy of not restricting entry into the market for UK services and networks. See "Market entry". Mercury merged with three cable operators in April 1997 to form Cable and Wireless Communications ("CWC"). For certain market share information relating to BT and its competitors, see "Item 9 – Management's Discussion and Analysis of Financial Condition and Results of Operations".

Market entry

Since the BT/Mercury duopoly of national fixed-link public telecommunications services was terminated in 1991, HM Government has issued over 160 new licences to companies providing a range of local, regional and national services. Many operators also provide international telephony by means of international simple resale. In December 1996 the BT/Mercury duopoly of international facilities was also ended, and around 80 international simple voice resale licences have been issued.

The UK market is now fully open to entry and, except in cases where use of a scarce resource such as radio spectrum is required, there is a presumption that licence applications will be granted. There are no restrictions on entry by non-UK firms.

New entrants to the market are not subject to the same degree of regulation as BT and have fewer obligations in their licences.

Many of the entrants to the UK market since 1991 are large companies with substantial financial resources and significant telecommunications experience, much of it gained as the monopoly or dominant operator in an overseas market. Their activities in BT's key markets have led, and will continue to lead, to a loss of market share by BT with consequential effects on revenues. In particular, BT has lost market share in international telephony and expects to experience further loss as the new international facilities operators extend their activities.

Service providers

Changes proposed in Oftel's February 1997 statement on the regulation of supply of services by BT to independent service providers – those who use BT and other operators to provide services to their customers – have been implemented through amendments to BT's Licence. The measures include an updated classification of BT's Systems Business and Supplemental Services Business (effective from 1 April 1998); increased flexibility for BT to offer lower prices to independent service providers; and increased transparency of the relationship between BT's Systems Business and its Supplemental Services Business. The impact of these changes will not be clear until the market for service providers has developed sufficiently. BT believes that it is unlikely to be material.

Cable operators

HM Government policy has been to restrict BT from competing in the conveyance and provision of broadcast visual services over its national network, but this policy is currently under review. See "HM Government's review of broadcasting restrictions".

Over 150 cable television franchises have been awarded, which cover about 75% of the UK population. Cable operators are allowed to offer voice telephony and other telecommunication services in addition to "entertainment" services, independently of the company and other public telecommunications operators. Rate of growth has been rapid: in April 1995, 872,000 cable telephony lines had been installed in 45 franchises. By January 1998, there were 3,442,000 lines in 127 franchises. The growth in the number of cable telephony lines is expected to have an increasingly adverse effect on the company's share of the UK residential market as the operators build out their networks.

In recent years the UK cable market has been consolidating and the largest cable operators currently include CWC, Telewest and NTL.

HM Government's review of broadcasting restrictions

HM Government published a review of broadcasting restrictions on 23 April 1998 which announced proposals to lift the broadcasting restrictions on BT and other national telecommunications operators by 2001. Although BT has no current plans to offer multichannel TV in direct competition with cable, HM Government's policy change will allow BT to develop broadband access using Asymmetric Digital Subscriber Loop ("ADSL") and services to homes that could incorporate broadcast elements.

Mobile services

HM Government policy places certain restrictions on BT competing in the provision of mobile telecommunication services in the United Kingdom. HM Government has sometimes licensed existing participants in the UK telecommunications market and, in other cases, has expressly excluded existing licensees from participating in new services.

Although BT has a majority share in Cellnet and resells cellular services through its mobile communications unit, the company itself is prohibited from providing mobile services under the Licence and was excluded from participating in the consortia licensed in 1991 by HM Government to operate PCNs. PCNs compete with existing mobile networks (using different radio frequencies), and also with fixed networks (including BT's local network).

HM Government has also licensed mobile telephone operators, Cellnet, Vodafone, Orange and One 2 One to provide fixed-link services in addition to their mobile operations, while continuing to exclude the company and other national fixed-link operators from providing mobile services. BT is allowed to provide radiopaging services, but under a separate licence, vested in the company.

In his statement "Pricing of Telecommunications Services from 1997", the Director General said that he was concerned about the level of payments made by the company to Cellnet and Vodafone for having calls terminated on their networks and, in his opinion, the consequent high prices for calls from the company's fixed network customers to mobile customers of Cellnet and Vodafone. A consultative document "Prices of Calls to Mobile Phones" was published in March 1997 in which the Director General concluded that prices were still too high. In March 1998, the Director General referred BT, Cellnet and Vodafone to the MMC for investigation into BT's retail charges for calls made from BT's fixed network to Cellnet and Vodafone's networks and Cellnet and Vodafone's charges to BT for terminating such calls. 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 and results of operations in view of the continuing reduction in prices.

Number portability

Number portability enables customers to retain their numbers when changing the operator providing their telephone service. Subject to certain specified criteria being met, the Director General has the power to direct BT to provide portability to other operators, and he has made such a direction.

Following a referral of the issue of charges to the MMC in 1995, and the subsequent publication of the MMC's report, BT's Licence was amended in July 1996 to reflect the MMC's recommendations of allocating various defined categories of costs of providing number portability. In April 1997 the Director General announced that he intended to amend all fixed operators' licences to require them to provide portability on the same basis as BT, and he published proposed licence amendments accordingly.

Portability of geographic numbers was introduced, starting with single numbers, in May 1996, and further development of geographic number portability is under way. A trial of non-geographic number portability (eg 0800 freephone numbers) started in May 1997. The Director General has also announced his intention of extending portability to encompass mobile numbers from July 1998.

The introduction of number portability makes it easier for BT's customers to switch to another operator (although the facility is available in both directions), and may lead to some reduction in the customer base.

Prices

BT is now subject to price controls in the UK at two levels: retail and network.

Retail price controls

The company has been subject to controls over certain retail prices since 1984. The controls have allowed some room for flexibility as to the individual price changes and have generally taken the form of requiring it to reduce, or limiting the extent to which it can increase, charges for two groups of services being public switched telephone services and private circuits. The services subject to these controls used to account for the majority of the company's revenues until 31 July 1997 when the controls were relaxed as described below. No competitor is subject to price controls.

The company is not prevented from benefiting from the improvements in efficiency by any limitation to a specific rate of return on capital. While all prices must be consistent with requirements in the company's Licence, such as that they must not be unduly discriminatory, the company is not generally required to obtain the prior approval of any regulatory authority for specific retail price changes.

BT is subject to two basic sets of UK retail price controls, one on certain public switched telephone services, essentially call charges and exchange line rentals, and one on certain private circuits. Each price control is based on a formula calculated by reference to the UK Retail Prices Index ("RPI"). The weighted average increase in prices charged for the services covered by the controls, in each twelve-month period beginning 1 August, cannot exceed a fixed percentage below the change in RPI (referred to as "RPI minus" the fixed percentage) for the twelve months to the preceding 30 June. If the RPI increases by less than the fixed percentage, or falls, the company must lower the weighted average prices for those services accordingly. In calculating the increase or reduction to these prices, each item is weighted in proportion to the contribution it made to the company's turnover from services covered by the respective price controls in the previous financial year. Any permitted increase forgone (or excessive reduction made) in one year can count when establishing the company's prices in future years.

The price control formula for public switched telephone services which applied from August 1993 until July 1997 was RPI minus 7.5.

The retail price control for public switched telephony, applying from August 1997 to July 2001, is RPI minus 4.5. Although it is measured on services used by the lowest 80% of BT's residential customers classified by bill size, controlled prices must be offered to all customers. Price changes required by the control must be made by 1 February each year but any excessive reduction in one year may generally be carried forward to the next control year.

BT has also given an assurance that a normal residential bill will (for the same level of usage) not increase by more than RPI and that a "control" price package will be made available to business customers. The "control" package for business customers provides call charges, which are no higher than the prices used for calculating adherence to the residential price control, and line rental increases will be no more than the increase in RPI. BT is free to offer other packages to business customers with prices which are lower than the "control" package prices. The required reduction in prices for the year commencing 1 August 1997 under the retail price cap is based on the RPI movement for the twelve months to June 1997 which was 2.94%.

The price control formula and the company's performance against the formula since 1 August 1993 have been as follows:

Price control formula	Year commencing 1 August				
	1993	1994	1995	1996	1997
% RPI movement for the relevant period (a)	1.22	2.62	3.52	2.14	2.94
RPI formula in effect (b)	(7.50)	(7.50)	(7.50)	(7.50)	(4.50)
% required reduction in prices (c)	(6.94)	(4.86)	(1.38)	(4.92)	(1.56)
% reduction in prices overall	(6.95)	(7.35)	(1.82)	(4.92)	(1.59)(d)

- (a) Annual increase in RPI to previous June.
- (b) From 1 August 1997, the RPI formula covers the main switched telephone services provided to the lowest 80% by bill size of BT's residential customers. The previous formula covered such services supplied to all residential and business customers.
- (c) After permitted carry forward of any unused allowance or shortfall from previous years.
- (d) Price changes implemented to 26 May 1998.

The price control for private circuits, applying from August 1997 to July 2001, applies to analogue and lower speed digital private circuits, the prices of which cannot be increased by more than the change in the RPI in any year. This control also applies to international private circuits.

Network charge control

The company operates under interconnection agreements with most other licensed operators, including mobile, international simple resale and cable operators, and is in negotiation with other licensed operators.

A network charge control regime running from 1 October 1997 to 30 September 2001 gives BT the freedom to set reasonable charges based on incremental costs for its standard interconnection services. The key feature of the new arrangements is the replacement of the system of annual charge determination by the Director General with one where, depending on the degree of competition for these services, charges are basket controlled (i.e. at RPI minus 8), price cap controlled (i.e. no increases above RPI), or no longer subject to price controls. Those with little or no competition are normally subject to cap or basket controls, whereas fully competitive services are no longer subject to price controls.

The network charge controls are based around RPI minus 'X' rules. The value of 'X' in the 'RPI minus' formula has been set at 8% for the period of control with accompanying timing constraints to ensure that within the charge control year price reductions are not delayed or increases introduced early. Failure to meet the RPI minus 8 constraint must be remedied to the satisfaction of the Director General by making adjustments to the relevant charges either within the control year or in the following year. An obligation has been placed upon BT to publish a notification to the Director General and other licensed operators if it intends to amend existing charges or to offer new services.

BT is not allowed to discriminate unduly among operators or between BT's retail operations and other operators with respect to both price and quality of service. BT is also required to publish and have audited financial statements for the regulatory "businesses" and "activities", in order to support the linkage of costs with interconnect prices and with a view to providing demonstrable evidence that BT is neither behaving in a discriminatory fashion nor unfairly subsidising its activities.

The regulatory “businesses” for which separated accounts are currently produced are: access; apparatus supply; network; retail systems; supplemental services; and residual services. No organisational separation was required by the interconnect and accounting separation (“ICAS”) amendments. Financial statements for the businesses and activities are published both on a historical cost basis and on a current cost basis. BT has also published the accounting documents associated with the ICAS requirements. Historical cost financial statements for the businesses and activities for the 1998 financial year are required to be published by 31 July 1998. BT will also publish current cost financial statements for the businesses and activities for the 1998 financial year including long-run incremental cost information for the network business by 30 November 1998.

Relationship with HM Government

HM Government’s interest in BT

The special rights redeemable preference share of £1 par value in the company (the “Special Share”), formerly held by HM Government, was redeemed at par on 10 September 1997. The Special Share, which could only be held by HM Government, did not carry any rights to vote at general meetings, but entitled the holder to receive notice of, attend and speak at such meetings. Certain matters, in particular the alteration of specified Articles of Association of the company, including the article relating to limitations which prevent a person from owning or having an interest in 15% or more of BT’s voting shares and the article requiring BT’s executive Chairman to be a British citizen, required the written consent of the holder of the Special Share. HM Government, as holder of the Special Share, did not have a right to appoint or nominate directors of the company.

Commercial and other relations with HM Government

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

BT can be required by law to do certain things and to provide certain services for HM Government. The Licence obliges BT to provide certain services for HM Government departments, such as priority repair of certain telephone lines. In addition, the Secretary of State has statutory powers to require BT to take certain actions in the interests of national security, international relations and the detection of crime.

See “Regulation, competition and prices” with respect to the powers of HM Government and the Director General to regulate telecommunications within the United Kingdom.

Windfall tax

In the 1998 financial year HM Government imposed a windfall tax on the “excess profits” of certain privatised companies, including BT. The windfall tax resulted in a charge to BT of £510 million, payable in two equal instalments. The first instalment was paid in December 1997 and the second instalment is payable in December 1998. The tax liability arose in July 1997, and was charged as an exceptional item in BT’s financial statements for the 1998 financial year.