

Risk Factors

The following describes some of the significant risks that could affect us. Additionally, some risks may be unknown to us and other risks, currently believed to be immaterial, could turn out to be material. All of these could materially adversely affect our business, turnover, profits, assets, liquidity and capital resources. They should also be considered in connection with the forward looking statements in this document and the warning regarding forward-looking statements on page 143 of this document. These risks include the risks relating to the BT Wireless business which is proposed to be demerged.

Financing

To finance several significant investments and acquisitions since November 1999, we have substantially increased our outstanding debt. In part because of this increase, our credit ratings were reduced during the second half of 2000 and during May 2001. Any further reduction in our ratings would increase our cost of borrowings. Subsequent downgrades may hinder our ability to expand and develop our business and may affect our ability to raise short-term finance.

During the 2001 financial year our borrowings, less short-term investments and cash, have risen from £8.7 billion as at 31 March 2000 to £27.9 billion as at 31 March 2001, primarily as a consequence of our cash investments in 3G mobile licences and from acquiring interests from our former partners in European joint ventures.

Credit rating downgrades

Due to this increase in borrowings, as well as decreased stability and predictability of revenue streams from our new business sectors such as mobile data services, the capital expenditure investment needed to enhance our competitive position in a fast changing technological environment and the increasingly competitive nature of the UK telecommunications market, our credit ratings on our long-term debt and senior debt ratings were downgraded in August and September of 2000 and in May 2001. This downgrade in credit ratings has caused an increase in our borrowing costs. Before goodwill amortisation the net interest charge was covered 2.6 times by total operating profit for the year ended 31 March 2001 down from 8.8 times in the year ended 31 March 2000. Our ratio of earnings to fixed charges (which consists mainly of gross interest expense) calculated in accordance with US GAAP has decreased from 5.9 in the year ended 31 March 2000 to 0.2 in the year ended 31 March 2001. Furthermore, our net debt has increased during April 2001.

In February 2001, Standard and Poor's placed us on "CreditWatch with negative implications". Approximately

one-third of our debt (i.e. the debt that was issued after the ratings downgrades in August and September 2000) is subject to covenants which would increase the interest rate if we were subjected to further downgrades. In addition, further downgrades would increase the cost of future borrowings, and subsequent downgrades may hinder our ability to expand and develop our business and may affect our ability to raise short-term finance.

Debt reduction

We have indicated that we intend to reduce our debt by at least £10 billion by 31 December 2001. Our ability to achieve this will largely depend on the success of the rights issue and our ability to effect our restructuring programme including certain disposals. In November 2000, we announced details of our restructuring plans to focus resources on specific geographical areas and optimise the positioning of our individual businesses within their respective markets. We said we would focus on Western Europe and Japan and float up to 25% of BT Wireless and Yell and that a flotation of BT Ignite was possible, to be reviewed by the end of 2001. In addition, we described proposals to create a new holding company to enhance corporate flexibility, and provide scope for further subsidiary flotations where advantageous to shareholders. We also detailed plans to create a new network company, NetCo, which would be both structurally and managerially separate. Following this corporate reorganisation, and subject to the satisfactory outcome of necessary discussions with HM Government and Ofcom, our intention was to float up to 25% of NetCo. Our aim was to reduce net debt of the group by December 2001 by at least £10 billion using the cash proceeds from the sale of equity in these various IPOs, together with the proceeds of disposals of non-core businesses and assets.

The weakness of the IPO market, particularly for telecommunications companies, has caused us to review whether the sale of equity in BT Wireless and Yell in an IPO still constitutes the best option to strengthen our capital base. In addition to the rights issue, we plan to demerge BT Wireless (creating a new holding company at the same time). On demerger the capital structure of BT Wireless is planned to include up to £2 billion of net debt. We are reviewing our plans for Yell and are currently considering proposals to sell or demerge Yell. We continue with our programme of non-core disposals which to date has included agreements to sell our Japanese investments and our investment in Airtel which, when completed, should reduce our net debt by £4.4 billion. Completion is conditional upon relevant regulatory and other approvals in Japan and Europe. We have also announced plans to realise the value of our UK property portfolio through a sale

Risk Factors

and lease back transaction as well as the sale of our London headquarters. We have also decided that there will not be a final dividend for the 2001 financial year and that there will be no interim dividend for the 2002 financial year. As a result, we believe we are on track to meet our target to reduce group debt by at least £10 billion by 31 December 2001 using the cash from disposals already announced and the anticipated proceeds from the rights issue. However, we cannot assure you that these disposals will occur as planned or that the rights issue will be fully taken up. The rights issue is not being underwritten and therefore we are not guaranteed any minimum proceeds from the rights issue which is due to close on 15 June 2001. We may not be able to achieve our intended debt reduction if our plans do not succeed on the proposed terms or take significantly longer to achieve than we anticipate. If we do not achieve this reduction there is a likelihood that our credit ratings will be further downgraded.

Notwithstanding our expectation that we should be able to meet our £10 billion debt reduction target, we anticipate that the ratings of the company are likely to be downgraded because of the view taken of the prospects for our fixed network business and for third generation services. We believe, however, that the group will be able to maintain an investment grade rating. We cannot assure you that the successful implementation of the restructuring will have this result.

In the course of the 2002 financial year, we expect net debt to increase as a result of net cash outflows from our planned capital expenditure and interest payments. However, our debt reduction and cash generation focus continues and our target is now to reduce net debt to between £15 billion and £20 billion in Future BT by 31 March 2002. Proceeds from our restructuring plan will be used to reduce net debt.

Our ability to pay dividends in the future depends on the success of the new companies created by our restructuring programme.

We have, since shortly after our incorporation in 1984, annually paid interim dividends in February and final dividends in September. The interim dividend we paid in February 2001 was 8.7 pence per ordinary share, unchanged from the previous year. However, as part of our debt reduction and restructuring plans, we have decided that there will be no final dividend in respect of the 2001 financial year and that there will be no interim dividend for the 2002 financial year. The total cost of the dividends for the 2000 financial year was approximately £1.4 billion. We expect that Future BT will recommend a final dividend in respect of the 2002 financial year.

Future dividends, if any, to be received by our shareholders will depend on the progress of the individual companies created by our restructuring programme. These companies will determine their own dividend policies in accordance with their respective capital structures, cash requirements and the markets in which they operate. As a result, we can give no assurance to our shareholders as to the level of dividends, if any, to be paid after February 2002 by us, or any of the new public companies created by our restructuring.

We are undertaking a substantial restructuring of our businesses to improve our position in a rapidly changing market place. Our plans for the implementation of the restructuring are incomplete in many respects, and the success of the restructuring will depend in part on factors that are beyond our control. As a result, we cannot assure our shareholders that the goals of our restructuring plan will be fully achieved. We also cannot assure shareholders that completion of the restructuring plan will result in the success of our strategy.

As discussed above, we are undergoing a major restructuring of our business from a centrally organised one to one based on several lines of business. Although the lines of business were mostly established by 1 July 2000 and BT Retail and BT Wholesale were split in October 2000, the detailed organisation continues to be developed and changed. In particular, we have not yet determined the exact form of the new UK network company, NetCo, which is to take over the majority of BT Wholesale's activities and provide network services to telecoms operators and service providers. Delay in implementation of the restructuring may lead to the new managements not being able to concentrate on developing their businesses with certainty, or to pursue opportunities in their respective marketplaces and may lead to staff retention problems. As we refine the plans for our restructuring, we may encounter significant obstacles that we have not yet anticipated and that prevent us from fully implementing the restructuring or fully achieving our strategic goals.

Certain aspects of our restructuring plans require prior consultation with our regulators, the Secretary of State for Trade and Industry and the Director General of Telecommunications who heads Oftel. We expect to conduct extensive discussions with Oftel regarding our restructuring plans. Depending on the outcome of these discussions, regulatory restrictions may impact our ability to complete the restructuring according to our existing plans.

We cannot assure our shareholders that we will be successful in completing the restructuring as currently planned

or that we will achieve all of our strategic goals. Failure in this regard could adversely affect our strategic and competitive position.

We need to obtain a number of consents, approvals and/or clearances before we can demerge BT Wireless. At this stage, we cannot be certain that we will obtain these on acceptable terms or within our proposed timetable.

For the BT Wireless demerger to proceed as planned, we need first to obtain consents, approvals and/or clearances from: our shareholders; the High Court of Justice in England and Wales; the Department of Trade and Industry; the Inland Revenue; and certain regulators.

We expect to seek shareholder approval at an extraordinary general meeting to be held towards the end of 2001. Our current intention is that the demerger of BT Wireless will take place at the same time as the creation of a new holding company which would be undertaken through a court approved scheme of arrangement.

The trustee of certain of BT's notes and bonds has confirmed, having taken independent legal and financial advice, that, subject to certain conditions being met, it will not take any steps in relation to the demerger of BT Wireless. The principal condition is the successful completion of the rights issue; other conditions include the information provided by us to the trustee remains accurate and no new and materially adverse factor emerges. Further certification will be required by the trustee prior to implementation of the demerger. There can be no guarantee that this certification will be obtained.

We can give no assurance that the rights issue will be deemed successful by the trustee or that we will be able to obtain the necessary consents, approvals and/or clearances and consequently that we will be able to implement the demerger of BT Wireless.

We have asked the Department of Trade and Industry to confirm our expectation that our main telecommunications licence, the BT Cellnet licence, and our 3G licence will remain in effect after the demerger. There are also a number of non-UK licences, including those for Viag Interkom and Esat Digifone for which consent or notification will be required. We will require certain clearances from the UK Inland Revenue to confirm the tax treatment of the companies involved in the demerger and for our shareholders on demerger.

We are facing significant competition in the markets in which BT Wireless operates, which may reduce our revenues and profitability.

There is intense competition in all of the markets in which BT Wireless operates. BT Wireless is competing with leading global wireless operators as well as virtual network operators,

traditional fixed line providers, resellers of wireless services and cable operators. In many countries new competitors may also enter into their markets as additional bands of spectrum and licences for wireless communications may be auctioned or otherwise offered or sold by the governmental authorities.

We expect that recent market trends in the telecommunications industry, such as accelerating technological convergence, will also intensify competition in all existing markets, both from existing competitors and new entrants. Continuing competition has and may lead to: price erosion on products and services; reduction in market share; loss of existing or prospective customers and increased difficulty in retaining customers; increases in handset subsidies; faster network expansion and upgrading; and more rapid development of wireless technologies.

BT Wireless's competitive position will depend also on the efficiency and success of marketing and branding initiatives and its ability to anticipate and respond to various competitive factors affecting it, its competitors and its industry. Such competitive factors include, amongst other things, new services and products, network coverage, pricing of wireless services and handsets, the quality of customer service and changes in consumer preferences.

Any failure by BT Wireless to compete effectively or successful competitive behaviour by its competitors would have a material adverse effect on our operating results and prospects for so long as BT Wireless remains within the group.

If our subsidiary Viag Interkom continues to incur losses, we may not realise a return on our investment.

We have invested approximately £12 billion, mainly in the 2001 financial year, in Viag Interkom, our newly acquired subsidiary business in Germany against which a goodwill impairment charge of £3 billion was made in the year to 31 March 2001. Viag Interkom, a startup established in 1997, has incurred losses in each of its completed financial years. Viag Interkom has an estimated 7% share in the highly competitive German mobile phone market as at 31 March 2001. Under a licence it acquired in 2000, Viag Interkom is required to develop a 3G mobile network in Germany. Although the development of a 3G mobile network will require substantial capital expenditure by Viag Interkom, we cannot be certain that the demand for 3G mobile products and services will justify the related costs or that Viag Interkom will develop a competitive 3G network. We have not managed a similar sized operation outside the United Kingdom in recent years. We can give our shareholders no assurance that Viag Interkom will cease incurring losses in the foreseeable future, nor that we will

Risk Factors

be able to make an economic return from our investment in the company.

Our investments in third generation mobile licences and networks may not generate an economic return.

We have invested approximately £10 billion in 3G licences in the 2001 financial year, principally in Germany and the United Kingdom. These licences are for the use of particular parts of the radio spectrum for 20 year periods and are required to enable us to provide advanced mobile data services to our customers. We have given undertakings to build a mobile network infrastructure to give a certain level of geographic coverage in Germany, the United Kingdom and The Netherlands. We expect that this will require a further investment of up to £10 billion over a five year period. Completion of this investment may be hindered by more stringent planning controls over the siting of masts, particularly in rural areas. In addition, we expect BT Wireless to apply for a 3G licence in the Republic of Ireland which will entail further licence and roll out costs.

The technology for the new services is not yet fully developed by the suppliers of the handsets and other equipment to be used by us and our competitors in providing the services. Developing 3G technology may take longer than we anticipate and prove not to be superior to the existing technologies. The size of the market for these services is as yet unknown and may fall short of the industry's expectations. We cannot be certain that the demand for such services will justify the related costs. In some locations, the investment, although required under the licences, may not be commercially desirable. In addition, we have a number of significant competitors in each geographic market.

We expect to roll out our 3G network at the same time that many of our competitors roll out their own 3G networks throughout Europe. This, combined with the limited number of suppliers of 3G network equipment, is likely to create high demand for, and may extend the delivery times of, such equipment, which may cause delays in the construction of our 3G networks.

The potential level of competition, together with these uncertainties, means that we cannot give our shareholders any assurance that we will make an economic return from our investments in 3G licences or networks. In the event that we fail to generate significant revenue from our planned 3G mobile service offerings, we may not be able to meet financial obligations incurred in relation to the 3G network or otherwise and our business, financial condition and results of operations may suffer.

We face strong competition in the UK fixed network services.

We continue to have a significant market share in some aspects of the UK fixed network services. In particular, approximately 82% of exchange lines in the United Kingdom were in our network as at 31 March 2001. Regulators are attempting to promote competition in this area by allowing other operators to site equipment in or adjacent to our exchanges (local loop unbundling) and to make it easier for our customers to route some or all of their calls over competitors' networks (carrier pre-selection). Reduction in our market share in the fixed network may lead to a fall in the group's turnover and an adverse effect on profitability. Unlike other operators, we continue to be obliged by the current regulatory regime to serve customers in the United Kingdom, whether or not such provision of service is economic, and the two competitive measures described above may have the effect of accelerating the diversion of our more profitable existing customers without us being able to reduce our costs commensurately. These changes in the regulatory environment and ensuing increased competition on our fixed network may cause adverse effects on our business, results of operations, financial condition and prospects.

If we are subject to significant price controls, we may lose market share, competitive advantage and our future profitability may be affected.

Most of our fixed network activities in the United Kingdom are subject to significant regulatory controls. The controls regulate, among other things, the prices we may charge for our services and the extent to which we have to provide services to our competitors. In recent years, the effect of these controls has been to cause us to reduce our prices. In addition, the regulators are considering bringing our UK wireless operations under wider price control which may have the effect of further reducing the prices we can charge for mobile services. We cannot assure our shareholders that the regulatory authorities will not increase the severity of the price controls, or extend the services to which controls apply, or extend the services which we have to provide our competitors. These controls may adversely affect our market share, the severity of competition and our future profitability.

Our business depends on our ability to exploit technological advances quickly and successfully.

We operate in an industry with a recent history of fast technological changes. We expect that new products and technologies will emerge and that existing products and technologies will develop further. We cannot predict the actual effect of these technological changes on our business or on our

ability to provide competitive services. For example, presently there is evidence of some substitution by customers who use their mobile phones for day-to-day voice calls in place of making such calls over the fixed network. Additionally, some calls are now being routed over the internet in place of the traditional switched network. If these trends accelerate, our fixed network assets may be used uneconomically and our investment in these assets may not be recovered through profits on fixed network calls and line rentals. Impairment write-downs may be incurred and margins may decline if fixed costs cannot be reduced in line with falling turnover.

Health concerns from mobile phone handsets and masts may reduce customer demand and affect profitability.

There has been speculation that mobile phone handsets give off harmful radiation to their users and that transmitter masts emit such radiation, adversely affecting the health of people in their vicinity. Although research has failed to provide evidence of any links between such radiation and long-term harmful effects on people's health, HM Government has issued a guideline, suggesting that people below the age of 18 should limit the time spent using mobile phones and some schools have not allowed masts to be sited on their premises.

Increased speculation regarding health risks or any subsequent substantiation of such risks may result in an adverse effect on customer demand, may affect the future sitings of masts and/or may lead to legal compensation claims or other liabilities.