

Business review

The review is divided into the following sections:

- 8 Introduction
- 8 Group strategy
- 9 Restructuring
 - Rights issue
 - Demerger of mmO2
 - Acquisitions and disposals
 - Concert
- 11 Lines of business
- 11 BT Retail
 - Voice services
 - New-wave business
 - Brand extension
 - Net-centricity
 - Customer satisfaction
- 14 BT Wholesale
 - Changing market conditions
 - Strategic objectives
 - Broadband
- 15 BT Ignite
 - Meeting customers' needs
 - Business realignment
 - Cash management
 - Customers
- 16 BTopenworld
- 16 BTextact Technologies
- 17 Our people
- 18 Regulation, competition and prices
 - Regulation in the UK
 - Competition
 - Pricing regulation
 - Non-UK regulation
 - Other significant changes and issues
- 22 Relationship with the UK Government
- 23 Legal proceedings

Please see cautionary statement regarding forward-looking statements on page 140.

All customer numbers are given as at 31 March 2002, unless stated otherwise.

EBITDA = Earnings before interest, taxation, depreciation and amortisation

Introduction

BT Group plc is the listed holding company for an integrated group of businesses that provide voice and data services in the UK and elsewhere in Europe. British Telecommunications plc is a wholly-owned subsidiary of BT Group and holds virtually all businesses and assets of the BT group. Our collective aim is to create shareholder value through service excellence, brand leadership, our large-scale networks and our existing customer base, and also through developing and marketing new, higher-value broadband and internet products and services.

BT Group plc was formed when the mmO2 business (comprising what had been BT's mobile activities in the UK, the Netherlands, Germany and the Republic of Ireland) was demerged on 19 November 2001. Shareholders received one share in mmO2 plc and one share in BT Group plc for each share they previously held in British Telecommunications plc. Trading in BT Group plc and mmO2 plc shares began on 19 November 2001.

BT consists principally of four lines of business: BT Retail, BT Wholesale, BT Ignite and BTopenworld.

In the year ended 31 March 2002 (the 2002 financial year), 89% of our revenues were derived from operations within the UK, where we are the largest full service telecommunications operator, serving over 21 million customers. The largest lines of business within the group, BT Retail and BT Wholesale, operate almost entirely within the UK, addressing the consumer, business and wholesale markets, and offer a broad spectrum of communications products and services. Our aim is to increase profitable revenues from data and advanced broadband and internet services and to reduce further the proportion of revenue and profit generated by fixed-line voice services.

For a summary of turnover for our products and services for the years ended 31 March 2000, 2001 and 2002, see the table on page 9.

Group strategy

BT's three-year strategy is to create value for shareholders through being the best provider of communications services and solutions for everybody in the UK, and for corporate customers in Europe, achieving global reach through partnership.

The lines of business will focus on seven strategic priorities:

- to deliver the highest levels of customer satisfaction performance and reduce the number of dissatisfied customers each year;
- to achieve organic profitable revenue growth, while constraining capital expenditure;
- to put broadband at the heart of BT, expand the market for broadband services and create a media-enabled network;
- to provide solutions and other value-added services for multi-site corporate customers in Europe;
- to place all UK networks under a single management structure and to limit investment in legacy voice and data platforms, while migrating operations to new platforms;

- to use the strength of the BT brand to move into broadband services for consumers; and also into related markets, such as communications solutions and business mobility services for major business customers; and information and communications technology for SMEs; and
- all delivered by diverse, skilled and motivated people.

Restructuring

During the 2002 financial year, which saw some of the worst conditions in the telecoms, media and technology (TMT) sector for many years, we completed a radical restructuring, the aims of which were to enhance customer service, create greater management focus and reduce debt.

The main features of the restructuring were:

- the UK's largest-ever rights issue;
- the demerger of the majority of BT's mobile businesses to create two separate listed companies, BT Group plc and mmO2 plc;
- the disposal of significant non-core businesses and assets;
- the unwind of Concert, BT's joint venture with AT&T;
- the establishment of customer-focused lines of business; and
- the reduction of our net debt from £27.9 billion at 31 March 2001 to £13.7 billion at 31 March 2002.

Rights issue

On 10 May 2001, BT announced a three for ten rights issue at 300 pence per share. This was well supported by shareholders and closed, as planned, on 15 June 2001. Some 1.98 billion new shares were issued to shareholders who took up their rights, raising £5.9 billion, net of expenses.

Demerger of mmO2

On 19 November 2001, we completed the demerger of mmO2, comprising what were BT's wholly-owned mobile assets in Europe: O2 UK (formerly known as BT Cellnet), O2 Communications (Ireland) (formerly known as Esat Digifone), Telfort Mobiel, Viag Interkom, Manx Telecom and Genie.

BT and mmO2 have, through arm's length negotiations, entered into a number of agreements to define the continuing relationship between the groups. These include:

- until November 2004, we will exclusively promote the mobile products and services of O2 UK to the business market in the UK;
- until 31 March 2003, we will not offer mobile products and services to the consumer market in the UK solely under the BT brand. We may, however, offer mobile products and services under the BT brand if co-branded with the brands of other mobile network operators, and may offer bundled fixed and mobile products under the BT brand; and
- parts of mmO2 are able to use some of our trademarks and brands, including the BT name and the half piper logo, on a transitional basis until 31 March 2003.

Acquisitions and disposals

During the past three financial years, BT made a number of significant acquisitions, including taking stakes in Japan Telecom and J-Phone and control of Viag Interkom, Esat Telecom and Esat Digifone. During the latter part of that period, reflecting the change in the group's strategy, we disposed of a number of businesses and assets, including Yell, Japan Telecom, J-Phone and Airtel. This has enabled us to focus on our core businesses and to reduce net debt. We also transferred assets and businesses to Concert, which was subsequently unwound (see "Concert" below).

Turnover summary

Years ended 31 March

	2002 £m	2001 ^a £m	2000 ^a £m
Fixed-network calls	5,266	5,655	5,908
Exchange lines	3,926	3,674	3,526
Receipts from other operators	3,113	2,814	1,974
Private services	1,039	1,091	1,135
Solutions	1,661	1,074	915
Customer premises equipment supply	688	726	847
Other sales and services	2,754	2,107	1,820
Total continuing activities	18,447	17,141	16,125
Wireless products	2,262	2,760	2,170
Yellow Pages	169	743	629
Other sales and services	11	105	33
Intra-group	(330)	(322)	(242)
Total discontinued activities	2,112	3,286	2,590
Group turnover	20,559	20,427	18,715
Share of associates and joint ventures' turnover	4,764	9,937	3,364
Trading between group and principal joint venture	(681)	(698)	(176)
Total turnover	24,642	29,666	21,903

^aFigures for the 2000 and 2001 financial years have been restated to conform with the method of classification used in the 2002 financial year.

Our recent programme of acquisitions and disposals included:

Acquisition and disposal of Viag Interkom

In January and February 2001, we took sole control of Viag Interkom by acquiring the remaining 45% which we did not already own from E.ON (formerly VIAG AG) for £4.6 billion, having already bought Telenor's 10% interest for £1 billion. The wireless business of Viag Interkom was transferred to mmO2 on demerger. The fixed-line business of Viag Interkom is now served by BT Ignite Germany.

Acquisition and disposal of Japan Telecom and J-Phone

In June and July 2001, we sold our 20% interest in Japan Telecom, and our interests in J-Phone Communications and the J-Phone group companies to Vodafone, for £3.7 billion in cash. This is more than four times our original investments, which were made in stages, beginning in the 2000 financial year.

Acquisition and disposal of Cellnet

On 10 November 1999, we acquired the 40% interest in Cellnet Group, our mobile cellular phone operator, that we did not already own for £3.15 billion. This business was transferred to mmO2 on demerger.

Acquisition and disposal of Esat Digifone

In April 2001, we acquired, for £0.9 billion, the remaining 49.5% of Esat Digifone, a mobile operator in the Republic of Ireland, that we did not already own. This followed our acquisition of control of Esat Telecom Group in March 2000 for approximately £1.5 billion. Esat Digifone (now O2 Communications (Ireland)) was transferred to mmO2 on demerger. The fixed-line business of Esat is now served by BT Ignite Ireland.

Disposal of Yell

On 22 June 2001, we sold Yell Group, our international directories and e-commerce business, to a newly-formed company, jointly owned by Apax Partners and Hicks, Muse, Tate & Furst for approximately £2 billion. Yellow Book USA, an independent classified directory publisher in the USA, which we had acquired in August 1999 for £415 million, was sold as part of Yell.

Acquisition and disposal of Telfort

In July 2000, we took full control of Telfort, our Dutch joint venture, by acquiring, for £1.2 billion, the 50% of Telfort that we did not already own. The wireless business of Telfort was transferred to mmO2 on demerger. The fixed-line business of Telfort is now served by BT Ignite Netherlands.

Disposal of Airtel

On 29 June 2001, we completed the sale of our 17.8% interest in Airtel Móvil S.A. to Vodafone for £1.1 billion. This represents a return of almost five times our original investment in the Spanish wireless operator.

Disposal of sunrise communications

On 30 November 2000, we sold our 34% stake in sunrise communications in Switzerland to Tele Danmark for the equivalent of £464 million in cash, realising a profit of over £450 million.

Disposal of British Interactive Broadcasting (BiB)

In May 2001, we exercised our option to sell to BSKyB our interest in BiB, our interactive television joint venture, known as "Open". The consideration, to be received in two tranches (in June 2001 and November 2002), was to the value of approximately £240 million. The first tranche was in BSKyB shares and the second tranche will be in BSKyB shares or loan notes. Shares received are subject to certain lock-in restrictions. In addition, if BiB were to reach a certain value in 2003, we would receive a further tranche, with a value of approximately £120 million.

Disposal of Maxis

On 15 November 2001, we sold our 33.33% interest in Maxis Communications in Malaysia to our partner in Maxis, Usaha Tegas Sdn Bhd, for £350 million in cash.

Acquisition and disposal of Rogers Wireless

On 29 June 2001, we completed the sale of our entire interest in Rogers Wireless in Canada to AT&T Wireless Services for £267 million. We had acquired our interest in Rogers Wireless through a 50/50 partnership with AT&T in August 1999, when, together with AT&T, we acquired the equivalent of approximately 33% of the share capital of the company.

Acquisition of Control Data Systems

On 31 August 1999, we acquired Control Data Systems (now known as Syntegra USA), an international systems integration company based in the USA, for £213 million.

Property sale and leaseback

As part of a wider property outsourcing arrangement, in December 2001, we completed the sale and leaseback of the majority of our UK property portfolio to Telereal, a 50/50 joint venture partnership between Land Securities Trillium and The William Pears Group, for £2.4 billion in cash. Around 6,700 properties — offices, telephone exchanges, vehicle depots, warehouses, call centres and computer centres, totalling some 5.5 million square metres — were effectively sold. The transaction also included the transfer of approximately 350 employees from BT to Land Securities Trillium (Telecom) during the first quarter of 2002.

Under these new arrangements, Telereal is responsible for providing accommodation and estates management services to BT. In return, we pay Telereal around £190 million of annual rental, increasing at 3% a year, for use of the freeholds. In addition, BT has transferred the economic risk on a large portion of its leased properties to Telereal in return for an annual rental commencing at approximately £90 million per annum. We have the flexibility to vacate

approximately 35% by rental value of the estate, including existing lease ends, over the contract term at no extra cost.

We have retained direct ownership of approximately 220 properties. A number of these were retained with a view to obtaining better value through other means.

Concert

On 1 April 2002, following an announcement in October 2001, we completed the unwind of Concert, our international joint venture with AT&T, which involved the return of Concert's businesses, customer accounts and networks to the two parent companies.

As a result of the unwind, we have largely taken back into our ownership those parts of Concert originally contributed by us to the joint venture, while AT&T has taken back into its ownership those parts it originally contributed. We have acquired substantially all of Concert's managed services network infrastructure in Europe, Africa, the Middle East and the Americas, and substantially all of the customer and supplier contracts that we originally contributed to Concert. Concert assets that have been returned to us are now managed by BT Global Business, part of BT Ignite, while Concert customers that have been returned to us are now managed partly by BT Global Business and partly by BT Retail.

Simultaneously with the completion of the termination of the Concert joint venture, AT&T acquired our Canadian joint venture, through which we held an indirect minority shareholding in AT&T Canada.

Under the Canadian joint venture agreement, BT was committed to participating in AT&T's future obligation to acquire all publicly-traded shares of AT&T Canada. AT&T has now taken full ownership of the joint venture and BT no longer has any involvement in the joint venture, nor any obligations in relation to AT&T Canada.

Lines of business

The following table sets out the group turnover for each of our lines of business in the 2002 and 2001 financial years.

Years ended 31 March	Group turnover	
	2002 £m	2001 £m
BT Retail	12,085	12,063
BT Wholesale	12,256	11,728
BT Ignite	4,476	3,468
BTopenworld	222	140
Other	373	138
Intra-group	(10,965)	(10,396)
Total continuing activities	18,447	17,141
mmO2	2,665	3,388
Yell	171	749
Intra-group	(724)	(851)
Total discontinued activities	2,112	3,286
Totals	20,559	20,427

BT Retail

Years ended, or as at, 31 March	2002	2001
Group turnover	£12,085m	£12,063m
Group operating profit	£1,102m	£888m
No. of employees ('000)	50.8	53.6

Note – before goodwill amortisation and exceptional items

BT Retail is the UK's largest communications service provider, by market share, to the residential and business markets. It trades under one of the UK's leading brands – BT – and is the prime channel to market for the other businesses in the BT group.

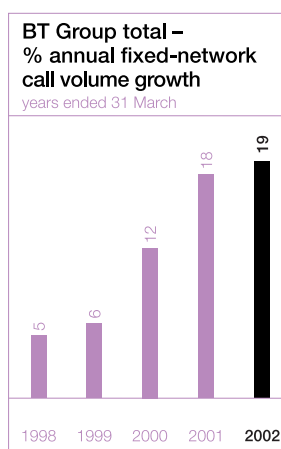
BT Retail supplies business and residential customers with a wide range of communication products and services, including voice, data, internet and multimedia services. It also offers a comprehensive range of managed and packaged communications solutions.

BT Retail's strategy, which has customer satisfaction as its cornerstone, aims simultaneously to achieve the goals of reducing costs and improving customer satisfaction. During the 2002 financial year, BT Retail made significant progress in implementing its strategy with the aim of:

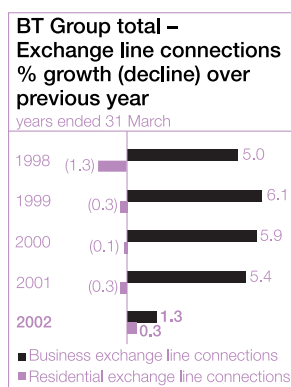
- minimising the decline in revenue from its traditional core business;
- growing existing new-wave revenue and developing fresh initiatives;
- establishing brand extension opportunities in adjacent markets; and
- improving its efficiency.

Voice services

In the residential, fixed-voice call market, BT Retail's share remained stable over the year at 73%, having fallen from 79% in mid-1999 to 74% by mid-2000. Within the business sector, there was a reduced level of market share loss, with a market share of around 48%.



As at 31 March 2002, BT Retail had more than 28 million customer lines (exchange line connections). Some eight million of these were business lines and lines for other service providers; the remainder were for residential customers.



Exchange line turnover, comprising rental and connection charges, accounted for approximately 30% of our revenues in the 2002 financial year. The number of BT Group's business lines grew by 1.3% over the year, with high-speed ISDN services being the main driver behind this growth. Despite competition from other fixed-line providers, the number of residential lines increased marginally (by 0.3%), reversing the previous declining trend, due to a combination of customers installing second lines and customers returning to us from other operators.

In a highly competitive market, BT Retail has developed innovative pricing packages designed to meet the needs of small, medium and major businesses and residential customers.

During the 2002 financial year, BT Retail further developed its innovative BT Together pricing package, which offers reduced rate calls and other benefits for a fixed monthly fee. To date, more than 10 million customers have signed up for the package. The scheme was enhanced to include the option of unmetered UK calls at evenings and weekends. An option including unmetered off-peak internet calls (SurfTime) was also made available. The UK calls package offers more than 6,000 hours of unmetered national calls per year for every BT customer. This new addition to the BT Together family has so far attracted 610,000 customers.

As at 31 March 2002, 71% of residential customer call minutes were made by BT Together package subscribers.

In the residential market, the successful rollout of pricing packages contributed to stabilising our share of the fixed-line voice market and improving customers' perception of price and value for money.

In June 2001, BT Answer 1571, a free answering service for all our residential customers, was launched. This service, which takes messages if a person is out, engaged on another call or surfing the internet, has proved highly successful; more than five million customers had signed up for this service by 31 March 2002.

As well as adding to our call packages and range of services, we listened to our customers and made it easier for them to understand how their charges had been calculated, by introducing a new and clearer bill. This had the added advantage of being more environmentally friendly

than its predecessor, saving up to 730 tonnes of paper a year.

New-wave business

Existing new-wave business, including ISDN lines, customer premises equipment, digital private circuits and conferencing, showed growth of 10%.

In December 2001, BT Retail announced a target of a 4% per annum increase in incremental revenue from existing new-wave business by the 2005 financial year.

In addition, it announced a plan to introduce a number of new-wave initiatives to generate incremental revenue of £825 million by the 2005 financial year. These include:

- a stronger push into broadband products and services, with the announcement in April 2002 of BT Broadband, which redraws the way internet access is sold. BT Broadband, which will be widely available from Autumn 2002, allows customers always-on, high-speed direct access to the internet over a single home phone line. It strips out services like e-mail, free personal web space and content. This leaves customers free to create a portfolio of services and content they want, and means that they do not have to pay for services they may not need;
- an increased focus on mobile solutions, working with mmO2 and other partners; and
- wireless local area network (LAN) solutions for businesses and consumers.

In April 2002, BT Retail announced that it would be launching a new portfolio of mobile services in June 2002. This will mean a wide range of products for business customers and the creation of a new service provider business in the mobile market, giving unified billing and customer service for the first time under the BT brand. As part of BT Retail's mobility strategy, it was also announced that we planned to build the UK's first public access wireless LAN network by installing around 400 'hotspots' (access points in airports, stations, hotels, etc.) by June 2003. We estimate that there will be up to 4,000 sites by June 2005 and we will be working closely with our partners Motorola and Cisco to build the new network.

Other examples of this new-wave strategy include:

- a major initiative, e-payphones, was announced in December 2001. This involves a partnership with Marconi to launch the world's largest public network of multimedia payphone terminals. We will install 28,000 of the new Marconi-built terminals, which will offer full internet access, e-mail and text messaging. Rollout started in April 2002, with 3,000 terminals planned to be in place in the UK within a year;
- during the 2002 financial year, we connected up to 2,000 SMEs a week to broadband. An NOP Research Group poll in February 2002 confirmed BT as the number one internet service provider for businesses with between one and 49 employees. During the 2002 financial year, we connected a UK business to the internet every five minutes, on average; and
- our commitment to broadband for SMEs led to our enthusiastic involvement in the ACT NOW programme in

Cornwall, a demand-led initiative to encourage businesses in the county to gain the support they need to move into the new broadband economy. The £12.5 million project includes around £5.25 million of European funding and will run for three years. The project could act as a blueprint for the development of broadband in other regions of the UK where, without this kind of partnership approach, deployment would be uneconomic.

An area of focus for new-wave initiatives is the public sector, where:

- we continued to work with the National Health Service to provide electronic links into doctors' surgeries and hospitals, leading to faster and easier booking of hospital beds and appointments, and the shortening of hospital waiting lists;
- the National College for School Leadership Online was underpinned by an infrastructure developed and hosted by us. This flagship Government initiative is being rolled out to all school leaders and offers quality training, advice, resources and guidance at the touch of a button;
- Liverpool City Council chose us to be its partner in the 'e-transformation' of its services. Via Liverpool Direct, a range of solutions is resulting in a step change in the quality of services being delivered to the city's inhabitants; and
- Bracknell Forest Borough Council chose us to provide a single, multi-functional smart card, enabling residents to obtain local services, including transport, attendance records and meals in schools, and leisure activities in sports centres.

Brand extension

BT Retail embarked on three brand extension initiatives in the 2002 financial year, linking-up with market leaders:

- a partnership deal with the leading UK digital TV broadcasters to provide our customers with attractive digital television offers alongside their telephony and internet needs. To date, these deals have generated more than 300,000 leads for the TV partners;
- strategic alliances with Cisco, Dell, Microsoft and O2 UK to provide hassle-free, integrated information and communications technology (ICT) solutions for SMEs. As at 31 March 2002, more than 900 companies had signed up for the packages, generating revenue of more than £33 million; and
- a strategic partnership deal with Siebel Systems, a world-leading provider of customer relationship management (CRM) applications software. This also involved launching Contact Central, a new-generation, multimedia contact centre solution for SMEs. Since its launch in October 2001, £108 million in new revenue has been achieved in the field of CRM.

In extending into the CRM field, BT Retail also linked up with other key players, including Accenture, Nortel, Avaya, Cap Gemini Ernst and Young, CosmoCom, Extraprise, Genesys and MarketBridge.

Net-centricity

BT Retail's website (accessed through www.bt.com) provides residential and business customers with an e-commerce channel through which they can access information and services.

The site is a key part of BT Retail's drive to become more net-centric, by giving its customers increased opportunities to deal with the company over the internet. This gives customers a choice of more ways to contact us and results in significant cost efficiencies.

www.bt.com is one of the largest sites of its type in the UK, with 2.5 million registered users at 31 March 2002. Orders for more than £71 million worth of products and services were made or initiated through the site during the 2002 financial year.

Customer satisfaction

Delivering customer satisfaction is the cornerstone of BT Retail's strategy. BT Retail's key objective is to provide customers with a significantly better experience than any of its main competitors by March 2003.

Performance is measured monthly and, during the 2002 financial year, the SME and consumer segments each achieved better customer satisfaction scores than competitors in nine months out of 12. The major business sector, for which a customer satisfaction tracker has only been in place since May 2001, bettered the competition nine times in the first 11 months of the survey's operation.

Service is a key driver of customer satisfaction and, during the 2002 financial year, there was sustained improvement in several areas. Consumer provision was 3.9% better (in terms of the percentage of customers satisfied overall) than in the 2001 financial year, while there were improvements of 2.2% in business provision and 3.9% in consumer repair, with a slight decline of 0.6% in business repair.

These achievements were driven by a number of key initiatives including:

- reducing repeat faults through better focus and coaching, and by our engineers using their new laptop computers to help them in their work. The result was a 19% reduction in repeat faults in the three months ending 31 March 2002, compared with the same period in the 2001 financial year;
- keeping customers informed by giving them a clear commitment when a job starts and keeping them in the picture at all stages until it is completed to their satisfaction. 4.5% more customers were satisfied with the quality of communication with us than at the same time last year;
- contingency planning to cope with peaks of activity caused by bad weather and other surges of demand. As a result, peaks of work were fewer and less acute than in the previous year, with the workstack of outstanding faults being, on average, 20% lower; and
- encouraging customer-centric behaviours by adopting an end-to-end approach, covering job definition and recruitment through to coaching and performance management. This approach was implemented across the

'150' customer service function and piloted among the engineering community.

Towards the end of the 2002 financial year, BT Retail announced a key initiative in its drive to improve customer service and increase efficiency — a plan to create a network of 30 next-generation multi-function contact centres. A total of £100 million will be spent on the new centres, which will be multimedia, have more seats and use leading-edge CRM technology to provide consistent standards, a better customer experience, a state-of-the-art working environment and significant cost savings.

As part of the project, more than 50 existing call centres will close over the next two years.

BT Wholesale

Years ended, or as at, 31 March	2002	2001
Group turnover	£12,256m	£11,728m
Group operating profit	£2,242m	£2,538m
No. of employees ('000)	29.8	30.0

Note – before goodwill amortisation and exceptional items

BT Wholesale provides network services and solutions within the UK to communication companies, network operators and service providers, and to other BT lines of business.

Its 29,800 skilled employees manage the largest capacity communications network in the UK, with the greatest geographical reach and customer coverage. 120 million copper pair kilometres and six million optical fibre kilometres give it the ability to touch virtually every home and business in the country. Its 900 local and trunk exchanges handle an average of 300 million calls every day.

The 2002 financial year was characterised by:

- the launch of a bold plan to accelerate the growth of BT Wholesale's new broadband business;
- good progress in growing new business sales and the wholesale "one-stop shop"; and
- the successful delivery of a strong performance, despite the difficult trading conditions in the UK TMT sector, through a focus on operating free cash flow.

Changing market conditions

As a result of the reversal in world markets following the dot.com crash, which has been especially pronounced in the communications industry, the wholesale telecommunications market is experiencing its most significant slowdown in many years. Approximately 5% of BT Wholesale's UK customers have gone into administration or the like, resulting in around £200 million of lost external sales.

Consequently, BT Wholesale's external turnover growth (including mmO2 as external) has slowed substantially, from over 30% in the 2001 financial year to below 19% in the 2002 financial year. Its internal turnover (mainly with BT Retail and BT Ignite) reduced by 1% in the 2002 financial year.

However, BT Wholesale responded quickly to the changed market conditions by cutting its capital expenditure from £2,273 million in the 2001 financial year to £1,974 million in 2002. This enabled it to grow free cash flow by 9% in the 2002 financial year in a tough market.

Strategic objectives

Throughout the 2002 financial year, BT Wholesale continued to drive its strategic objectives to:

- evolve the UK network from a predominantly fixed-voice technology towards data, Internet Protocol (IP) and mobile technologies;
- create a portfolio that will enable it to sustain traditional product revenues, while migrating its customers up the value chain to more advanced services, and providing a "one-stop shop"; and
- become the number one provider in the high-growth UK broadband market.

BT Wholesale has continued to invest in its network in a highly focused way, using new technology to grow scale and capabilities for the future. A total of 70 next-generation switches (NGS) have now been deployed to replace the trunk exchange network. In January 2002, the world's first hybrid NGS, using voice over asynchronous transfer mode (ATM) technology, was brought into service.

In addition, more than 700 digital local exchanges have now been enabled to redirect all internet-type calls originating from BT customers. These calls are grouped together and routed directly to BT's Dial IP platform and other operators' networks. This enhanced functionality in BT Wholesale's switched network is enabling the evolution from circuit switch and voice to packetised data and IP.

In line with its strategy to migrate customers towards more advanced services, BT Wholesale generated over £100 million from new business revenues, comprising sales of broadband and data products, network facilities management, and content and applications solutions. This represented a growth of 240%, compared with the previous financial year, and resulted from opportunities continuing to be sought and won through deeper customer relationships with the leading fixed and mobile operators and strategic customer and supplier partnerships.

In addition, BT Wholesale continues to invest in e-business channels to improve its responsiveness to competitive market needs and to reduce costs.

Broadband

BT Wholesale's most notable achievements in the 2002 financial year have been in the broadband arena. From 1 June 2001, we vested the end-to-end management of broadband digital subscriber line (DSL) in BT Wholesale. This move was designed to bring all elements of broadband DSL delivery under one management team, including platform development, product development and in-life management, implementation and service assurance, marketing and channel development. Since then, BT Wholesale has:

- met its target of enabling more than 1,000 exchanges for DSL services to ensure that over 60% of UK households are connected to a DSL-enabled exchange;
- announced plans to enable a further 100 exchanges, extending coverage to 66%;
- launched a series of product enhancements, including a self-install version of asymmetric DSL (ADSL) in January 2002, enabling more than 150 service provider customers to market attractive broadband product offerings;
- promoted broadband through joint marketing programmes with its service provider customers; and
- progressively reduced the price of wholesale broadband through a sustained programme of cost reductions based on scale economics, e-business automation, process improvements, improved network design and lower equipment costs. These culminated in significant price reductions announced in February 2002, which are expected to stimulate demand for one million broadband lines in the UK by Summer 2003.

So, even in a difficult year, BT Wholesale made a major contribution to the financial performance of BT and set out its aim to be the number one provider of wholesale broadband in the UK.

BT Ignite

Years ended, or as at, 31 March	2002	2001
Group turnover	£4,476m	£3,468m
Group operating loss	£(353)m	£(309)m
No. of employees ('000)	16.4	18.8

Note – before goodwill amortisation and exceptional items

BT Ignite is our business services and solutions division, serving customers worldwide.

Its strategy is to deliver managed networks and communications solutions to multi-site corporate customers with activities in one or more European countries, including customers who operate globally with needs in Europe.

BT Ignite, along with BT Retail in the UK, positions us as a leading provider of managed communications services and solutions to corporate customers with substantial European operations.

Meeting customers' needs

BT Ignite provides customers with:

A unique services portfolio, with significant reach and depth

Its European network covers 56,000 kilometres, linking to 300 large towns and cities, with 20 hosting centres spanning the continent and Europe's largest IP virtual private network capability.

It also has a worldwide network of partnerships, joint ventures and distributors to meet customers' needs in the USA and Asia.

BT Ignite's customers are increasingly international in their activities and require advanced, IP-based, high-performance services, with full functionality, delivered to all of their locations.

One example is multi-protocol label switching (MPLS), which BT Ignite was the first to launch internationally. MPLS-based, IP virtual private networks (VPNs) are the next generation of data networks for corporate customers, supporting voice, data and video applications. These networks offer more flexibility and greater service performance.

A customer-driven portfolio

BT Ignite's services and solutions portfolio is built around the needs of multi-site businesses. It includes:

- desk top equipment and software;
- web hosting services;
- network equipment and software;
- managed network services;
- transport and connectivity;
- integration services;
- network operations services; and
- network and business consulting services.

Extensive experience in delivering solutions and value-added services

Revenue in BT Ignite Solutions was £1,828 million in the 2002 financial year, up 17% on the previous year with some accounts growing by 50% in the 2001 calendar year.

Gartner analysts estimate that BT Ignite Solutions has 6.5% of the UK integrated communications market.

BT Ignite Solutions has around 5,000 employees and operates in over 20 countries through joint ventures and associate relationships. Syntegra, which provides global systems integration and consultancy expertise, employs around 5,000 highly-skilled people across the globe, with particular strengths in financial services and government.

BT Ignite has embarked on an aggressive plan to build on its UK solutions base and extend its skills, knowledge and expertise into its continental European sales and service teams.

Core to the needs of multi-site business customers is global account management and BT Ignite offers a single point of contact for sales and service for all its major customers.

Business realignment

During the year, BT Ignite was realigned to ensure that it retained its focus on multi-site corporate customers, and ceased activities that might distract from this strategy.

On 31 March 2002, we successfully transferred the management of our former Concert customers to BT Ignite (and BT Retail).

The Concert MPLS VPN platform, with its global presence in Europe, USA and Asia, is being integrated with the BT Ignite European platform, to enhance reach and coverage.

BT Ignite's global reach services (Frame, ATM, IP-VPN) extend to and across North and South America. This means that BT Ignite's products are delivered seamlessly from Europe to its own locations in the Americas, and delivered

locally through standard, non-exclusive interconnect and supply agreements with regional carriers.

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

BT Ignite will not make any new investments in SME or consumer businesses in Europe, including either the building or buying of infrastructure, or acquiring new customer bases. It will, however, continue to participate in existing SME and consumer businesses, as long as they are profitable.

Cash management

In 2002, BT Ignite reduced its capital expenditure by 35%, compared with the previous financial year. Operating free cash flow improved by over £400 million.

Customers

By focusing on the needs of multi-site business customers, BT Ignite has been able to improve customer service and increase efficiency. Examples include:

- BT Ignite's innovative e-business tools and applications include the Commerce One auction service, which enables companies to tender for supply contracts via a dedicated internet portal. This has helped Whitbread Group make procurement savings estimated at 15%;

- Hitachi (Europe) recently changed its business processes and systems. For this project, BT Ignite provided programme management, change management and strategic advice on a one-stop shop basis. The project included business process and organisational analysis, specialist intranet consultancy and design and implementation skills;

- Syntegra provided voice trading technology for 1,400 people in Merrill Lynch's new, state-of-the-art, London trading room — Europe's largest trading floor; and

- for GlaxoSmithKline, BT Ignite developed a network solution, designed to offer high availability and flexibility to maintain competitiveness, speed up time to market, improve cost effective management of research and development processes, and enable more efficient implementation and auditing of new regulations.

BTopenworld

Years ended, or as at, 31 March	2002	2001
Group turnover	£222m	£140m
Group operating loss	£(118)m	£(233)m
No. of employees ('000)	0.4	0.5

Note – before goodwill amortisation and exceptional items

BTopenworld is our internet service provider (ISP) arm. It provides consumers and SMEs in the UK with a range of narrowband and broadband internet access and related services.

BTopenworld's strategy is to provide services that help customers use and explore the internet, rather than seeking to provide content that is readily available on many other sites.

At 31 March 2002, BTopenworld had approximately 1.75 million UK ISP customers, giving an annual growth rate of 40%, including over one million customers on narrowband unmetered packages, making it one of the leading unmetered internet access providers in the UK.

BTopenworld is the UK's leading retailer of DSL broadband services, with 108,000 customers. From 1 April 2002, it cut the retail price of its broadband service from £39.99 a month to £29.99 a month for domestic and business users, having launched Plug & Go, a self-install broadband product, in March.

Under the *Powered* brand, BTopenworld is a market leader in the UK for wholesale internet virtual ISP services — providing internet access, e-mail, portal and content payment solutions to third parties. BTopenworld *Powered* manages 560,000 active access users and over one million active e-mail users on behalf of its partners, including MSN, Barclays, Tate and mmO2.

BTopenworld achieved a number of other key milestones during the 2002 financial year. It launched the UK's first satellite-based internet access service, targeting businesses in rural areas. As part of its strategy for stimulating demand for broadband and creating a platform for providing value-added services, BTopenworld purchased the UK's leading online games site, Games Domain, as well as dotmusic — Europe's most visited music website. These acquisitions give BTopenworld a leading presence in the fast-evolving online games and music markets. During the year, BTopenworld became the first UK ISP to launch an online music subscription service, www.btopenworld.com/classical.

BTextact Technologies

The services offered through our lines of business are supported by BTextact Technologies (BTextact), our internationally-renowned centre of communications technology, which delivers advanced communications technology foresight, innovation, solutions and services to BT.

BTextact generates competitive advantage for BT through strategic evaluation and deployment of the technologies, infrastructure and applications that underpin platforms, innovative services, operational efficiency and effectiveness, and world-class customer service.

The majority of BTextact's revenues currently derive from the provision of professional services to other parts of BT, helping them serve their customers in sectors such as finance, utilities and government. These services include evaluation, security, the creation and optimisation of complex networks and applications, and operational support systems. During the 2002 financial year, for the first time, it provided these innovative services to selected external customers, primarily communications service providers and their suppliers.

Major areas of research include next-generation internet; advanced data services; information and network security; software systems to support the management and integrity of networks worldwide; and the future impact of

advanced communications on lifestyles, education and healthcare.

BTexact is responsible for the exploitation, management and defence of over 14,000 BT patents, and has a policy of vigorous commercial exploitation of technology through:

- patent licensing (including a contract with ipValue to secure revenues from US and Canadian companies); and
- Brightstar, its in-house incubator which creates new technology companies.

The BTexact proposition is complemented by a wide range of partnerships with leading technology suppliers and universities throughout the world. Many of these have established a presence at BTexact's primary location, Adastral Park in Suffolk, which has become one of the UK's leading concentrations of hi-tech businesses.

In the 2002 financial year, we invested £362 million in research and development, primarily through BTexact, compared with £364 million and £345 million in the 2001 and 2000 financial years, respectively.

Other businesses

As at 31 March 2002, we held significant stakes in a number of other businesses, including Concert (see page 11), a 26% stake in Cegetel, a leading French telecommunications company, a 16.6% stake in L G Telecom, a mobile cellular telephone operator in the Republic of Korea, and a 29% stake in Blu, a mobile cellular telephone operator in Italy.

Our people

Number of employees in the group

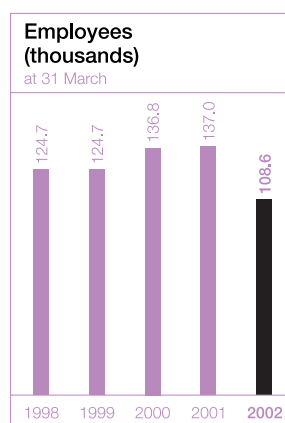
As at 31 March	2002 '000	2001 '000	2000 '000
UK	100.1	106.4	115.9
Non-UK	8.5	10.4	4.9
Total continuing activities	108.6	116.8	120.8
Total discontinued activities	–	20.2	16.0
Total employees	108.6	137.0	136.8

At 31 March 2002, BT employed around 108,600 people throughout the world, with 100,100 in the UK, making us one of the UK's largest employers.

The sale of the Yell directory business resulted in a reduction in BT employees of approximately 5,300 in June 2001. The demerger of mmO2 resulted in a further 15,800 people leaving the group in November 2001. The unwind of Concert is expected to lead to over 2,300 employees joining BT in the 2003 financial year.

During the 2002 financial year, as part of the continuing programme of reshaping the group, approximately 4,200 people left BT voluntarily, by leaver payments or voluntary redundancy.

Our search for new talent attracted 274 high-calibre graduates, 306 Modern Apprentices and 2,456 other new entrants. There were also 8,043 career development moves during the year.



We recognise that our people are critical to our success and believe that a reputation as a good employer helps win and retain an excellent workforce, which enhances our ability to serve our customers and generate revenues.

As part of this responsibility, we take the wellbeing of our people seriously. Stringent targets have been set for the reduction of occupational injury and ill health over the next four years and have been published in *Better World*, our social and environment report. These targets are aligned to, but are more challenging than, those set by the UK Government as part of its "Revitalising Health & Safety" strategy.

We recently won the Parents at Work/DTI Employer of the Year Award for our approach to helping our people balance their work and home lives. We have a wide range of options to support individuals throughout their working life, including home working, alternative attendance patterns and career breaks. In addition, we recently introduced a flexible retirement policy, giving employees greater choice about the nature and timing of their retirement.

During the year, we further developed our range of internal electronic people management systems. We have an award-winning e-human resources (HR) programme, which provides our people with an online, self-service approach to a broad range of HR products and services.

These HR services are provided to BT by e-peopleserve, our former joint venture with Accenture, under one of the biggest HR outsourcing contracts agreed to date in the UK. In February 2002, we sold our 50% interest in e-peopleserve to Accenture. A successful strategic partnership is being forged with e-peopleserve to the mutual benefit of both companies. Outsourcing HR transactions in this way, using the best technology platforms, has enabled a smaller HR team to focus more closely on its strategic agenda.

We encourage our employees to acquire shares in BT Group to enable them to share in our success. Following the introduction by the UK Government of the new tax-advantaged Share Incentive Plan, during the year we launched the BT Group Employee Share Investment Plan (the ESIP). From December 2001, we have operated the partnership shares section of the plan, which gives

employees an opportunity to purchase shares in the company out of pre-tax salary.

In previous years up to and including 2001, generally we have provided free shares annually to employees through our profit sharing scheme, the BT Employee Share Ownership Scheme. Since those schemes will cease to qualify for beneficial tax treatment, an amount of £25 million has been set aside under the ESIP for the allocation to employees in 2002 of free shares, which are held in trust for a minimum of three years. For 2003, the number of free shares allocated to employees will be linked to performance measures set by the Board.

In addition, employees have the opportunity, from time to time, to buy shares at a discount under the BT Group Employee Sharesave Scheme, a savings-related share option scheme. Share options are normally exercisable on completion of a three- or five-year save-as-you-earn contract. There is a similar savings-related scheme for employees outside the UK, and an employee stock purchase plan for employees in the USA.

Most of our employees are members of the BT Pension Scheme or the BT Retirement Plan, which are both controlled by independent trustees.

The BT New Ideas scheme, under which our employees are encouraged to put forward suggestions for improvements in the company's activities, generated more than 5,000 suggestions in the year, contributing to savings estimated to be around £30 million.

We run CARE, an annual employee attitude survey, and encourage managers and their teams to put in place action plans to address the issues that it highlights. Although it was a particularly challenging year for BT people, the annual survey revealed a modest but encouraging improvement in peoples' satisfaction with BT overall and with their respective line management.

An estimated 75% of our UK employees belong to one of two main trade unions recognised by the company. We have a good record of industrial relations and continue to have constructive relations with both unions, built on partnership and mutual respect.

We are an equal opportunities employer and are committed to developing a working culture that enables all employees to make their own distinctive contribution. During the financial year, we continued to demonstrate our commitment to equal opportunities and diversity. Throughout the year, we took a number of initiatives to widen our talent pool, ensuring that we are able to meet the needs of people with disabilities, caring responsibilities and mental health issues.

We are an active member of many equal opportunity and diversity organisations, including Opportunity Now and Race for Opportunity (RFO). These organisations enable us to benchmark our practice — achieving Gold standard from Opportunity Now and being recognised as the top performing private sector organisation by RFO.

Our supplier diversity programme, which aims to aid the growth of minority business enterprises in the UK by providing business-to-business mentoring, was recognised

as an example of best practice in this area. We also provide sponsorship in support of a wide variety of activities in the equality and diversity arena. For example, earlier in the financial year, we supported the BT Ethnic Multicultural Multimedia Awards (EMMA).

BT aspires to be a true learning organisation. We spend around £200 million a year on the training and development of our employees, who have access to a comprehensive portfolio of development and training options, including technical and commercial training, personal skills and management development.

We are making increasing use of the internet to deliver training and development programmes.

The BT Academy, a virtual corporate university, brings together all forms of learning, enabling BT people to access an extensive range of instructor-led and e-learning events, from short "just-in-time" training to Masters degrees. Links with professional bodies, the University for Industry (learndirect) and other learning communities help to enhance skills across the company to meet changing business needs. Our strategic imperatives are underpinned by the rapid deployment of new learning packages, using the Academy Learning System, one of the largest corporate learning management systems in Europe.

Regulation, competition and prices

The commercial environment in the United Kingdom and in the countries in which BT operates or wishes to operate is increasingly competitive and dynamic. However, we remain subject to extensive regulation, particularly in the UK, which can materially affect the way in which we carry out our business.

Regulation in the UK

The regulatory structure for UK telecommunications is set out principally in the *Telecommunications Act 1984*, which gives regulatory authority to the Secretary of State for Trade and Industry and the Director General of Telecommunications who heads the Office of Telecommunications (Ofcom). The Secretary of State and the Director General are each required to exercise their functions under the Act in the way which they consider is best calculated to ensure, as far as reasonably practical, that all reasonable demand for telecommunication services, including certain community services, is met and to secure the ability of licensed telecommunications operators to finance the provision of the services which they are licensed to provide. In addition, they are required, among other things, to promote the interests of consumers, purchasers and other users in the prices, variety and quality of telecommunication services and equipment, and to promote and maintain efficiency and effective competition among UK telecommunications operators.

With limited exceptions, a licence under the Telecommunications Act is required to run a telecommunication system in the UK. The Secretary of State is responsible for issuing licences after consulting the Director General.

The BT Licence

BT operates in the UK under a number of licences, the most important of which is our licence to operate our fixed-line public telecommunications network (the "Licence"). The Licence remains in force indefinitely, but the Secretary of State may revoke the Licence on 10 years notice. The Licence can also be revoked at any time on various grounds, including non-compliance with an enforcement order from the Director General. In September 1999, the Licence was modified to meet the harmonisation requirements of the European Union Licensing Directive.

The Licence contains terms and conditions designed principally to ensure the widespread provision of telecommunication services in the UK, to protect the interests of consumers and to encourage the development of effective competition in telecommunication services and network provision within the UK.

Under the Licence, we have to fulfil reasonable requests for access to voice telephony, low-speed data and fax transmission services, and reasonable access to public call boxes throughout nearly all the UK, including rural areas (these being the principal elements of the Universal Service Obligation).

Under the Licence, we must allow other licensed operators to interconnect with our telecommunications systems on cost-oriented, transparent and non-discriminatory terms.

We must comply with a variety of fair trading obligations, such as:

- a prohibition on showing undue discrimination between customers or unfairly favouring any part of our own business as against competitors on the basis of price terms or quality of our main services; and
- a prohibition on the unfair cross-subsidy of certain of our activities.

We must publish audited financial statements for the regulated "businesses" and "activities", in order to support the linkage of costs with interconnect prices and with a view to providing demonstrable evidence that we are neither behaving in a discriminatory fashion nor unfairly subsidising our activities. If it appears to the Director General that an unfair cross-subsidy exists between specified parts of our own business, we must take such steps as the Director General may direct to remedy the situation. The regulatory businesses for which separated accounts are currently produced are access, apparatus supply, network, retail systems, mobile, supplemental services and residual services. The Licence also contains provisions enabling the Director General to monitor our activities, including requirements for BT to supply him with information requested.

The Licence contains price control formulae, the overall effect of which requires us to reduce, or restricts the extent to which we can increase, the prices of many of our telephony services to the bulk of the residential market and also the prices for our interconnection services. In addition, the Licence contains certain specific restrictions on the terms on which we can trade. In particular, we are 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.

As a result of our international interests, a Licence condition prohibits us from doing anything, by act or omission, that would detract materially from our ability to meet our Licence obligations to provide UK telecommunication services and to do so to any standards specified by the Director General. BT's directors are required to submit an annual compliance certificate to the Director General.

The Director General may make modifications to a licence if the licensee does not object or the modification is deregulatory. Alternatively, changes to the licence may be referred to the Competition Commission. In either case, the Telecommunications Act requires public consultation before a licence can be modified. Licences may also be modified by legislation, including legislation implementing European Union directives into UK law.

European Union new Directives

In April 2002, the European Union adopted a new package of Directives for the regulation of electronic communications that will be implemented in all member states by July 2003. The new framework aims to be technologically neutral, to allow for reduced regulation as competition develops, to tailor regulatory rules and conditions to the minimum required to deal with identified problems, and to align the "significant market power" trigger for the regulation of specified market sectors more closely with the competition law concept of dominance (including joint dominance and leverage of dominance into related markets). The new framework also allows an enhanced right of appeal against regulatory decisions.

A Commission Recommendation will specify what markets should be analysed for the presence of players with significant market power. National Regulatory Authorities will be obliged to give the utmost regard to this, but will be free to depart from it if necessary. The Commission retains a veto over a limited set of National Regulatory Authorities' decisions in this area if they impact trade between member states.

Over the next 12 months, European National Regulatory Authorities will define markets and examine them for the presence of players with significant market power. Licences and licensing conditions will also need to be adjusted to comply with the Authorisations Directive, which calls for simpler and more streamlined general authorisation processes.

The Communications Data Protection Directive — originally part of the new framework, but now progressing separately — has not yet been finalised and may have cost implications for industry, particularly in the area of data retention.

Competition

Competition Act

In addition to telecommunications industry regulation, BT is subject to general competition law.

The *Competition Act 1998*, which came into effect in March 2000, brings the UK in line with European Community law by prohibiting anti-competitive agreements and concerted practices and the abuse of a dominant market position. In the case of telecommunications, the Director General of Telecommunications has concurrent investigatory and enforcement powers with the Director General of Fair Trading. They also have significant new investigative powers. Breach of the relevant prohibitions could lead to fines of up to 10% of turnover in the UK for each year of infringement (up to a maximum of three years) and/or result in claims for damages in the civil courts. There are also powers to order a company to cease an infringing activity.

There is a new statutory independent appeals mechanism for decisions under the Competition Act.

The competitive environment

The UK telecommunications market is fully open to entry and highly competitive. As a result, the UK Government and Oftel have indicated their expectation that it will be appropriate to move away from sector-specific (including licence-based) regulation to greater reliance on the Competition Act as individual markets become competitive.

In January 2000, Oftel published a strategy statement based on the principle that regulation should go no further than the minimum necessary to protect consumers. The strategy is underpinned by a programme of effective competition reviews, which are intended to ensure that the regulatory framework responds to changed competitive conditions: where it is found that competition is delivering benefits to consumers in the sectors reviewed, regulation will be reduced or withdrawn as appropriate. These reviews will need to be incorporated into the market reviews mandated by the new EU Directives, which will come into force in 2003. See "European Union new Directives" on page 19.

Although it is some years since the Telecommunications Act abolished our monopoly in telecommunications, obligations placed on BT, including pricing regulation and the requirement to provide universal service, discussed below, are generally more onerous than for other licensees.

Pricing regulation

Fixed network

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

Retail price controls

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

For services covered by the controls, the weighted average of base prices cannot increase in each year beginning 1 August by more than the annual change in RPI minus X. In times of low inflation, the overall effect of this control requires us to reduce our base prices.

The retail price control for public-switched telephony, applying from August 1997 to July 2001 and extended to July 2002, is RPI minus 4.5. Although it is measured on services used by the lowest 80% of our residential customers classified by bill size, controlled base prices must be available to all residential customers. The price control formula and our performance against the formula are set out in the table below.

Under the current controls, we have also given an assurance that a "control" price package will be made available to business customers. This package must have call charges no higher than the prices used for calculating adherence to the residential price control, and line rental increases no more than the change in RPI.

Under the price controls for private circuits that applied from August 1997 to July 2001, prices for domestic analogue and low-speed digital private circuits could not increase by more than the change in the RPI in any year. The application of the analogue price cap has been extended until July 2005 and the low-speed digital private circuits cap was removed in July 2001.

In addition, we are subject to a control on our retention for calls to O2 UK and Vodafone mobile phones. Our retention is defined by our retail price net of termination payments to the mobile operator. Under this control, applying from 1 April 1999 to 31 March 2002, our retention for calls to O2 UK and Vodafone cannot increase by more than RPI minus 7 each year. In February 2001, Oftel

Price control formula (RPI-X)

	Years commencing 1 August					
	1996	1997	1998	1999	2000	2001
% RPI movement for the relevant period ^a	2.14	2.94	3.75	1.35	3.32	1.93
X in price control formula ^b	7.50	4.50	4.50	4.50	4.50	4.50
% required reduction in prices ^c	(4.92)	(1.56)	(0.73)	(3.15)	(1.09)	(2.44)
% reduction in prices overall	(4.92)	(1.56)	(0.73)	(3.24)	(1.20)	(2.73)^d

^aAnnual increase in RPI to previous June

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

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

^dBase price changes implemented up to 21 May 2002

extended this control by four months until 31 July 2002, to be reviewed as part of the broader review of retail price controls.

Review of retail price controls

In March 2001, we accepted Oftel's proposal for a one-year extension of the current retail price controls of RPI minus 4.5 until 31 July 2002. Oftel said that it would consult again to determine whether there is sufficient competition to remove retail price controls from 1 August 2002. This further round of consultation began on 31 July 2001 with the publication of a consultative document by Oftel, *Competition in the Provision of Fixed Telephony Services* and continued with the publication on 31 January 2002 of Oftel's proposals in its consultative document *Protecting Consumers by Promoting Competition*. Under Oftel's major proposals in this latest consultative document:

- we would be required to provide a cost-based wholesale line rental product to competitors and new entrants at a regulated price and in a way that does not discriminate between our retail business and third party suppliers;
- for those services covered by the existing control, our prices to the lowest spending 80% of our customers would be pegged at their current level and not allowed to rise with inflation, using an RPI minus RPI price control. The services covered by the control would be extended to include our retention for calls to all four mobile networks, replacing the current separate control on BT for calls to Vodafone and O2 UK; and
- there would be a form of control at RPI plus 0 for some or all customers in expenditure deciles 3, 4 and 5, possibly achieved by an extension to the current Light User Scheme, which already has an RPI plus 0 protection within it.

In our response to Oftel submitted at the end of April 2002, we argued that considerably more retail de-regulation is possible going forward. Oftel's final proposals for retail price controls will be published in June, and we need to decide whether to object to these prior to the expiry of the current controls on 31 July 2002. If we object, the issues could be referred by Oftel to the Competition Commission, in which case the current retail price controls of RPI minus 4.5 would be rolled over for a further year from 1 August 2002 to 31 July 2003.

Network charge control

We operate under interconnection agreements with most other licensed operators.

A new network charge control period began on 1 October 2001 and will last for another four years. It requires us to set reasonable charges based on long-run incremental costs for our standard interconnection services. Depending on the degree of competition for these services, charges are cap controlled each year by RPI minus X (where X ranges from 7.5% to 13%) for services Oftel considers unlikely to become competitive in the near future; safeguard cap controlled (i.e. no increases above RPI during any relevant year of the overall control period) for

services likely to become competitive; and those services considered fully competitive are not subject to direct charge controls. The network charge controls that ended on 30 September 2001 capped charges for services unlikely to become competitive in the near future at RPI minus 8.

We must publish a notification to the Director General and other licensed operators if we intend to amend existing charges or to offer new services.

Non-UK regulation

We must take account of the regulatory regimes in the countries in which we operate or wish to operate.

European Union

The European Union is pursuing a policy of progressive liberalisation and harmonisation in telecommunications. Since January 1998, the provision of infrastructure and all telecommunication services has been liberalised in the European Union. Specific directives imposed rules for, among other things, voice telephony, leased lines and interconnection, with particular emphasis on organisations with significant market power and with a common set of principles for licensing and enforcement. These have largely been implemented in national legislation. The European Commission reviewed progress during 1999 and 2000 and a new regulatory framework has been agreed. See "European Union new Directives" on page 19.

Rest of the world

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

Other significant changes and issues

Local loop unbundling

In April 2000, following consultation, we accepted an amendment to our Operating Licence which required us to provide unbundled local loops to other operators to enable them to provide telecommunications services, including broadband DSL-type services, to end customers. The amendment came into force in August 2000 with local loop unbundling to be available from July 2001.

The EU thereafter passed a Regulation requiring local loop unbundling, line sharing and sub loop unbundling to be offered from 30 December 2000, thereby bringing forward the implementation date. We published a revised standard reference offer on 29 December 2000.

During 2001, we offered line sharing as required by the EU Regulation. Oftel will determine the prices for the

broadband frequency band of a shared loop after consultation and input by BT of relevant cost calculations.

On 20 March 2002, the European Commission announced infringement proceedings against five member states with regard to the Regulation on Local Loop Unbundling. This does not include the UK.

Carrier pre-selection

From 1 January 2000, the European Commission required the provision of carrier pre-selection (CPS) by Member State operators with significant market power. CPS allows customers to opt for certain classes of call to be carried by an alternative operator, selected in advance, without having to dial additional access codes.

Software changes to our local exchanges could not be introduced before January 2001 (for national and international calls) and January 2002 (for all other calls) and the UK Government applied to the European Commission for a deferment of our obligation. The European Commission granted a limited deferment until 1 April 2000, but decided that CPS should be provided in the interim by means of auto-diallers on customers' premises.

We introduced permanent CPS service in two phases, national and international calls on 12 December 2000, and all calls on 8 December 2001. Both phases were launched ahead of schedule, with interim CPS being withdrawn on the launch of phase 2.

Leased lines

Of tel published a Direction in respect of Partial Private Circuits (PPCs) in March 2001. This resulted from a review of the competitiveness of the national leased lines market in the UK and the need for regulation in this sector. Of tel concluded that more competition was needed in the provision of wholesale 'terminating segments' and required that we offer PPCs to other operators at cost-based prices. Following a period of industry negotiation on detailed terms and conditions for the new products, the PPC portfolio was successfully launched on 1 August 2001 encompassing 'local tails' leased lines at a range of bandwidths from 64kbit/s to 622Mbit/s. Take up of the new products by other licensed operators has been extremely rapid. Following subsequent requests from other licensed operators, Of tel has carried out investigations on a range of technical and commercial PPC-related issues, and is expected to announce the results of these investigations during Spring/Summer 2002. We are continuing to develop further enhancements to the initial product range.

Universal service

In August 2001, Of tel published the conclusions of its review of universal service (USO). We endorse Of tel's view that the time is not yet right to extend the USO to include broadband services. However, we are disappointed by Of tel's failure to acknowledge the strong case for industry funding of the significant net costs that fall on us in providing universal service. We remain committed to universal service.

Flat rate internet interconnection

On 26 May 2000, Of tel issued a Direction stating that we should provide an interconnection product under our licence for flat rate internet access call origination (FRIACO). The Direction requires us to provide call origination for internet access, not on the standard pence per minute basis but with charging based upon network capacity purchased. The Direction required us to offer FRIACO at the local exchange level from 1 June 2000. We complied with this Direction. In November 2000, Of tel began consulting on proposals to make FRIACO available at the next level up from the local exchange (at the digital main switching unit). A Final Direction on single tandem FRIACO was issued on 15 February 2001 requiring us to offer such a product, but with safeguards to prevent network congestion.

The charges for both FRIACO services are subject to RPI-X controls under the Network Charge Control regime.

UK Government's review of telecommunications and broadcasting regulation

The UK Government has completed a review of telecommunications and broadcasting regulation. A new regulatory body is being established, called the Office of Communications (Ofcom) to amalgamate the roles of the five existing regulatory agencies: the Director General of Telecommunications; the Independent Television Commission; the Broadcasting Standards Commission; the Radio Authority and the Radiocommunications Agency. Ofcom will be headed by a chairman and chief executive supported by executive and non-executive board members.

The legislation is being dealt with in two parts. The first stage is the *Office of Communications Act* passed in March 2002, which enables the board, office and budgets of Ofcom to be established, but does not enable Ofcom to exercise any regulatory functions. The second stage is a Communications Bill. The draft Bill was published in May 2002 and the final Bill is expected to be passed by Parliament by the Summer of 2003. It will confer regulatory functions on Ofcom, which will be able to take up those functions when the Bill is brought into force, possibly later in 2003. The main changes for telecoms will be the introduction of fines for breach of regulatory obligations and, in combination with statutory instruments to be issued by the Summer of 2003, the creation of a new regulatory regime to implement the requirements of the new EU directives for general authorisations, instead of individual licences. We support the Government's vision for the converging sector and welcome the intention not to apply broadcasting rules to internet content. We also welcome the provisions in the draft Bill for full rights of appeal against regulatory decisions, and the incorporation within Ofcom of incentives to reduce the level of regulation when appropriate.

Relationship with the UK Government

The UK Government collectively is our largest customer, but the provision of services to any one department or agency of the UK Government does not comprise a material

proportion of our revenues. Except as described below, the commercial relationship between BT as supplier and the UK Government as customer has been on a normal customer and supplier basis.

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

Legal proceedings

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