Regulatory Financial Commentary

2024

Disclaimer

This document contains **BT's commentary on the Regulatory Financial Statements (RFS) for the year ended 31 March 2024**. It reflects our own view and interpretation of the results presented in the RFS and has been produced without any involvement from Ofcom. We have chosen to make this commentary available to assist people in understanding the regulatory results and our interpretation of them. The content of this document and its publication do not form part of our regulatory reporting obligations arising from the SMP conditions imposed on BT.

BT Group

Contents

1 Introduction

Under the UK telecommunications regulatory framework, Ofcom regularly reviews markets to assess whether they are tending towards effective competition. Where companies are found to have 'Significant Market Power' (SMP), Ofcom imposes conditions accordingly. These include the "Regulatory Financial Reporting", a SMP condition that requires the production of the Regulatory Financial Statements (RFS). This commentary document explains our results in the markets where we[1] are deemed to have SMP for the year ended 31 March 2024 and should be read in conjunction with the RFS for that year. We also explain how the RFS results relate to the financial results presented in the BT Group Annual Report.

1.1 What are the Regulatory Financial Statements (RFS)?

The purpose of regulatory financial reporting is to provide Ofcom with the information necessary to:

- Effectively regulate the SMP markets, particularly the price controls.
- Help make informed regulatory decisions, such as cost information to support ongoing price controls.
- Assess the impact and effectiveness of decisions, for example trends in the usage of regulated services.
- Monitor compliance with SMP conditions.

For this reason, Ofcom directs BT to produce the RFS according to a defined framework and methodology. The RFS are a set of annual product profitability statements showing performance summary by SMP market (as defined by Ofcom) broken down by revenue, operating cost and capital employed. Ofcom's WFTMR 2021 directions[2] include what information should be published and which allocations and accounting principles to use while preparing that information. We take the revenues and costs for BT Group and apportion these to relevant products and services based on the rules as directed by Ofcom. The resulting key differences between the RFS and the BT Group Annual Report are discussed in Section 4.

[1] The terms 'the Group', 'the Company', 'BT', 'we', 'us' or 'our' refer collectively to BT Group plc and its subsidiary undertakings.
[2] Ofcom's "Promoting competition and investment in fibre networks: Wholesale Fixed Telecoms Market Review 2021-2026 Statement" published on 18 March 2021 for Openreach SMP markets.

1.2 Ofcom's WACC

Ofcom estimates forward-looking pre-tax Weighted Average Cost of Capital (WACC) at the time of the relevant market review. In the RFS, BT's actual returns on capital employed are measured as a pre-tax return on MCE[3] (Return on Capital Employed, or ROCE). The ROCEs may differ from Ofcom's WACC due to expected (e.g. investments, cost adjustments etc.) and unforeseen (e.g. inflation etc.) factors. This commentary explains the differences between BT's ROCEs in FY24 and Ofcom's estimated forward looking WACC as set for five years in the WFTMR 2021. Ofcom disaggregated its estimate of BT Group's WACC into Openreach legacy services at 7% (including copper and FTTC) and Other UK Telecoms (OUKT) at 7.8% including Openreach's leased lines and other products.

Ofcom did not determine a disaggregated WACC for FTTP in the WFTMR 2021. However it noted "that the systematic risk of FTTP could be higher than the average activity within OUKT (Other UK Telecoms), which would imply a bigger difference in the relative betas of copper-based and FTTP services" (Ofcom WFTMR 2021, paragraph A21.107). Ofcom made clear in the WFTMR 2021 that regulation should not curtail Openreach's opportunity to earn above its WACC over the lifetime of the FTTP investment reflecting the project specific risk at the time of the investment, in line with the "Fair Bet"[4].

We are required to report costs, revenues and resulting ROCEs for the products and services within each SMP market. It is important to note that ROCEs can fluctuate significantly in cases where the Mean Capital Employed (MCE) is small, and for some services it may be more appropriate to consider ROCE across wider markets.

[3] Mean Capital Employed (MCE) is calculated as the arithmetic mean of the opening and closing capital employed in the year.

[4] In WFTMR 2021 Ofcom's noted "an investment is a 'fair bet' if, at the time of investment, the expected return is equal to the cost of capital". In other words, should Ofcom consider it necessary to set regulated prices for higher speed FTTP products, it will only do so if investors had sufficient opportunity to make lifetime returns above the cost of capital commensurate with the downside risk they took when taking the decision to invest. WFTMR 2021, Vol. 4, paragraphs 1.114 to 1.117.

2 Adjustments to Results for Interpretation

To aid comparability, we have normalised the FY24 and FY23 results for inflation. Specifically, we have calculated the in-year P&L holding gains on copper and duct assuming that RPI inflation had been 2.4% in both years (in line with Ofcom market review assumptions). We have not adjusted for: (1) MCE as the increase in asset values is over the lifetime of assets and these are carried forward into future periods; and (2) Other CCA impacts (Supplementary Depreciation and 'other CCA adjustments'). The impact of this adjustment can be seen in the table below:

Openreach SMP Market	RFS Return £m	Adjustment £m	Adjusted Return £m	RFS Return £m	Adjustment £m	Adjusted Return £m
	FY24			FY23 Restated		
Physical Infrastructure	501	(1)	500	442	(1)	441
Wholesale Local Access	304	(119)	185	822	(580)	242
Business connectivity	395	(16)	379	378	(81)	297
Shared Ancillaries	27	0	27	46	0	46
Openreach SMP	**1,227**	**(136)**	**1,091**	**1,688**	**(662)**	**1,026**

3 Summary of Results

Annually, we are directed by Ofcom to restate our prior year reported results to incorporate changes as described in the Reconciliation Report (Appendix 2 to the RFS). This may include market changes (i.e. should Ofcom regulate new markets and/or deregulate existing ones) as well as methodology changes.

Restatements, detailed within Appendix 2 of the RFS, increased the FY23 ROCE for Openreach SMP markets from 5.4% (published) to 6.7% (restated).

Openreach SMP Market	Adjusted Return £m	MCE £m	Adjusted ROCE %	Adjusted Return £m	MCE £m	Adjusted ROCE %
	FY24			FY23 Restated		
Physical Infrastructure	500	7,150	7.0%	441	6,297	7.0%
Wholesale Local Access	185	7,791	2.4%	242	7,220	3.4%
Business connectivity	379	1,770	21.4%	297	1,714	17.3%
Shared Ancillaries	27	169	16.0%	46	164	28.0%
Openreach SMP	**1,091**	**16,880**	**6.5%**	**1,026**	**15,395**	**6.7%**

Openreach SMP ROCE declined slightly year-on-year from 6.7% to 6.5%. Small reductions in WLA ROCE are apparent as mix migrates towards FTTP, which is early in its product lifecycle, partially offset by improvements in Business Connectivity returns.

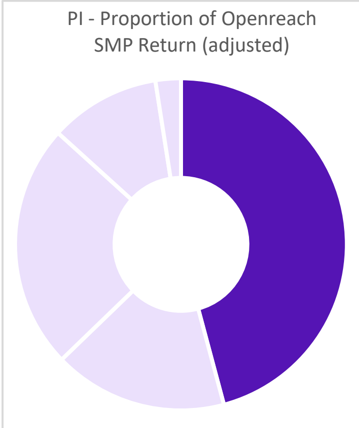
After normalising for the impacts of high inflation, ROCEs in each market are aligned with the life cycle expectations for the legacy and FTTP products:

- The RFS ROCE reflects in-year accounting profitability. ROCEs are lower in the early stages of the product life cycle (e.g. FTTP) when the network is being built in advance of demand, incurring more operating costs and depreciation compared with revenue (see section 4.2 for more detail). However, reported ROCEs become higher in later stages of the product life cycle as the customer base grows and there is limited, mainly maintenance, investment. This is the case with legacy copper and FTTC where we continue to see strong returns.
- As customers shift to new and faster products, the ROCE for FTTP is expected to grow and the higher ROCEs for legacy products will decline. Diminishing demand for legacy products towards the end of their life cycle will lead to lower volumes which will only be partially offset by price indexation (which was allowed by Ofcom under the WFTMR 2021 to promote competitive investment in gigabit-capable networks and to allow BT to recover its efficiently incurred costs). FTTP ROCE is expected to improve over time as take-up and revenues grow, and the network build is completed.

4 Market Results

4.1 Physical Infrastructure Market

Products



Physical Infrastructure (PI) enables Communications Providers (CPs) to share Openreach's existing access network infrastructure. CPs can utilise this infrastructure to deploy their own fibre networks. The PI market includes all the costs and assets relating to our physical infrastructure, revenues received from CPs sharing the infrastructure and a recharge to downstream markets (such as WLA, LLA and IEC) for their use of the infrastructure. As directed by Ofcom the recharges to downstream markets are set to recover fully allocated costs including the regulatory return on capital after deduction of charges to third parties for use of the infrastructure.

Adjusted Returns

	Revenue £m	Cost £m	Return £m	MCE £m	ROCE %	Revenue £m	Cost £m	Return £m	MCE £m	ROCE %	Ofcom WACC %
	FY24					FY23 Restated					
PI Market	855	355	501	7,150	7.0%	732	291	441	6,297	7.0%	7.0%

Currently, only c.3.5% of PI volumes are sold externally, although external sales are continuing to grow with over 160 CPs now registered for licences to use PI[5]. PI Market ROCE of 7.0% is achieved through a recharge of PI costs to downstream markets, as directed by Ofcom in WFTMR 2021.

Adjusted costs have increased by £64m, due to an increase in depreciation on PI duct and poles assets resulting from a larger asset base due to fibre investment and the impact of inflation on the asset valuation.

MCE increased by £853m, driven by CCA indexation resulting from higher inflation and continued investment in physical infrastructure for fibre deployment.

[5] According to Ofcom "as of the end of September 2023, 169 providers had registered with Openreach as customers of PIA, and nearly 90% had already built network using PIA or have placed orders to do so. Providers have ordered c.160,000km of duct (48,000km of which has been delivered) and approximately 1.2 million poles (373,000 of which have been delivered) to deploy networks)", Connected Nations 2023: UK report (ofcom.org.uk), page28.

4.2 Wholesale Local Access Markets

Products

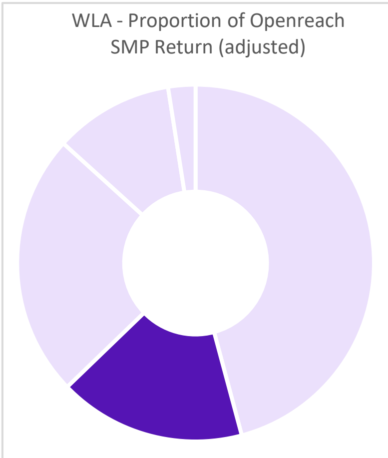
Wholesale Local Access (WLA) refers to copper and fibre lines used by Communication Providers (CPs) to connect a wide range of users to their voice or broadband nodes located in BT exchanges to provide telephone and internet services. WLA markets remain the biggest SMP markets by assets under the WFTMR[6] for the 2021-2026 period. The WLA markets are split by geography and by the nature of competition and Ofcom has determined that BT has SMP in both Area 2 and Area 3.

Wholesale copper products consist of two variants:

- Metallic Path Facilities (MPF) provide CPs with a copper connection between the exchange and the premises.
- Shared MPF (SMPF) is used by CPs to provide broadband over a copper line alongside a voice service on the same line (provided using Wholesale Line Rental, WLR) which may or may not be provided by the same CP.

Wholesale fibre products, or Generic Ethernet Access (GEA), consist of two main variants:

- FTTC uses fibre from the exchange to the street cabinet, then copper for the final link to the premises. FTTC is also used to provide Single Order GEA (SoGEA – broadband without the landline) products.
- FTTP uses fibre all the way from the exchange to the premises.



Adjusted Returns

	Revenue £m	Cost £m	Return £m	MCE £m	ROCE %	Revenue £m	Cost £m	Return £m	MCE £m	ROCE %	Ofcom WACC %
	FY24					FY23 Restated					
WLA Markets	3,431	3,246	185	7,791	2.4%	2,950	2,708	242	7,220	3.4%	7.0% / 7.8%

During the year, adjusted ROCE for the WLA market declined slightly, due to continued investment which drives early negative ROCE on FTTP products partially offset by increased demand for higher speed FTTP and FTTC services:

- Revenues increased by £481m due to increased volumes in higher speed FTTP and SoGEA and index linked price rises, partially offset by volume decreases in FTTC and MPF services.
- Adjusted cost increased by £538m and is mainly attributed to higher labour, energy, and software costs as well as increase in fibre depreciation - all consistent with FTTP roll-out.
- MCE increased by £571m, driven by an increase in asset base due to continued fibre roll out.

[6] See Ofcom's 2021 statement "Promoting competition and investment in fibre networks: Wholesale Fixed Telecoms Market Review 2021-26" (WFTMR).

Adjusted return and ROCE in the WLA market are split between FTTP and Legacy products as follows:

Product	Return £m	MCE £m	ROCE %	Return £m	MCE £m	ROCE %
	FY24			FY23 Restated		
FTTP	(468)	4,436	(10.6)%	(462)	3,792	(12.2)%
Legacy (Copper/FTTC)	653	3,355	19.5%	704	3,428	20.5%
WLA Total	185	7,791	2.4%	242	7,220	3.4%

In the WFTMR 2021 Ofcom had anticipated higher returns for legacy services in the short term to support fibre build by Openreach and its competitors. We expect that as legacy volumes decline, legacy products will earn lower returns as end customers migrate to new fibre services.

This contrasts with FTTP, where Openreach is currently in the investment phase, with ROCE currently below in-year WACC, but expected to increase as the product matures.

4.3 Business Connectivity Markets

The Business Connectivity markets are subdivided into the Leased Lines Access (LLA) market and the Interexchange Connectivity (IEC) Markets. Most business connectivity services are subject to charge control on a basket of products, across LLA and IEC, where annual price increases are capped at CPI.

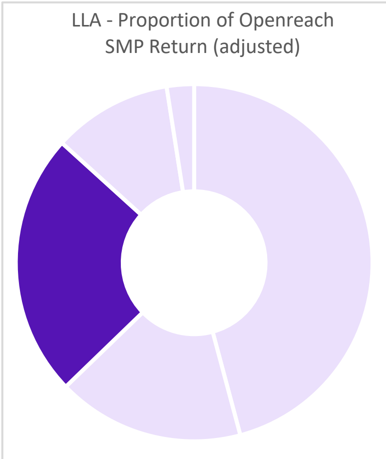
Leased Lines Access Markets

Products

LLA markets include the provision of leased lines access services which provide connections from BT exchanges to end-user business sites. The LLA markets are split by geography and the degree of competition with Ofcom determining that BT has SMP in Area 2, Area 3 and the High Network Reach (HNR) Areas.

The LLA markets contain Ethernet and Optical technology-based products and dark fibre services. The services include the following:

- Ethernet Access Direct (EAD) offers competitive point to point connectivity to UK businesses and infrastructure markets.
- Ethernet Backhaul Direct (EBD) is a highly efficient and cost-effective way of backhauling large volumes of data, quickly and securely.
- Optical Spectrum Access (OSA) provides a highly secure, flexible and cost-effective way of moving very large amounts of data between UK-wide locations via dedicated fibre links which use Dense Wavelength Division Multiplexing (DWDM) technology.
- Dark Fibre (DF) services offer access to optical fibres for data transmission where the telecoms providers can choose their own electronic equipment.



Interexchange Connectivity Markets

Products

IEC markets include the provision of dedicated circuits used for interexchange services that provide backhaul connections between BT exchanges in different geographic areas.

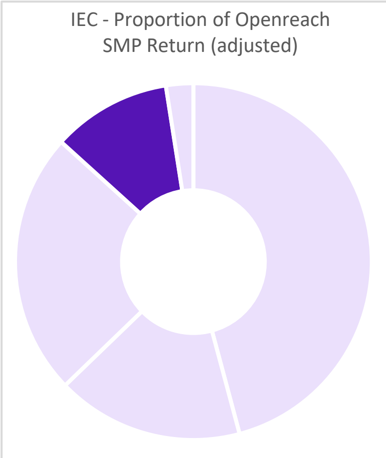
IEC reporting in the RFS is split into markets based on geographic areas and competition. Ofcom has determined that BT has SMP in the following:

- IEC - BT only exchanges: areas where only BT operates.
- IEC - BT+ 1: areas where only BT and one other CP currently operate.

The above markets are based on the specified postcode sectors as set out in the WFTMR Statements.

The IEC markets contain Ethernet technology-based products and dark fibre services. The services include those described in the previous section:

- Ethernet Access Direct (EAD).
- Ethernet Backhaul Direct (EBD).
- Optical Spectrum Access (OSA).
- Dark Fibre (DF).



Adjusted Returns for the Business Connectivity Markets

	Revenue £m	Cost £m	Return £m	MCE £m	ROCE %	Revenue £m	Cost £m	Return £m	MCE £m	ROCE %	Ofcom WACC %
	FY24					FY23 Restated					
LLA Markets	*891*	*630*	*261*	*1,636*		*783*	*600*	*183*	*1,574*		
IEC Markets	*210*	*92*	*118*	*134*		*202*	*88*	*114*	*140*		7.80%
Business Connectivity	1,101	722	379	1,770	21.4%	985	688	297	1,714	17.3%	

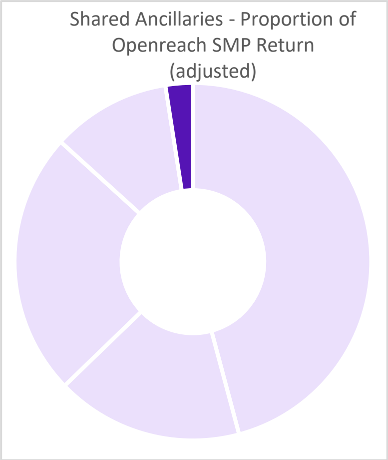
Adjusted ROCE in the Business Connectivity markets increased by 4.1 percentage points. Revenue increased by £116m as a result of higher demand for newer Ethernet and Optical service products due to their higher bandwidth capabilities and index linked price rises. An increase in adjusted cost of £34m is mainly attributed to higher energy costs and increased downstream charge from the PIA market as a result of increases in the duct asset base. MCE increased by £56m driven by the additional fibre assets required to support greater Ethernet volumes and the impact of asset holding gain increases due to CCA indexation.

ROCE remains above the Ofcom WACC of 7.8%. Product prices have increased in line with inflation reflecting the WFTMR price controls in which Ofcom directed that prices could be kept flat in real terms to encourage competition and investment.

4.4 Shared Ancillaries

Products

Ancillary means an associated facility or service which supports the provision of access to the electronic communications network. Shared ancillaries include Cablelink, Accommodation and Electricity charges.



Adjusted Returns

	Revenue £m	Cost £m	Return £m	Revenue £m	Cost £m	Return £m
	FY24			FY23 Restated		
Shared Ancillaries	142	115	27	144	98	46

All the services within shared ancillaries are charge controlled and either based on flat prices in real terms (CPI-0%) or based on purchase cost plus mark-up (basis of charges obligation). Services within this market do not typically have significant MCE balances owing to their nature and therefore ROCE is not a useful metric. The market continues to make small returns in line with expectations.

5 Reconciliation of the RFS to BT Group Annual Report

The RFS are prepared as directed by Ofcom using specific methodologies aligned to regulatory decisions. This results in different accounting treatments used in the Annual Report and the RFS. We continue our dialogue with Ofcom about the intention to improve transparency of the RFS and more closely align it to the accounting standards adopted for the Annual Report.

For FY24, the adjusted operating profit reported in the Annual Report is reconciled to the return reported in the RFS as below:

	Notes	Openreach £m	BT Group plc £m
Adjusted operating profit as per Annual Report		1,775	3,202
Specific Items	1	(128)	(987)
		1,647	**2,215**
Other trading differences	2	(31)	-
Net short term interest		(6)	(85)
Share of post-tax loss of associated and joint ventures		-	(21)
Installation costs treated as operating expenses	3	(142)	(142)
CCA adjustments	4	121	124
Rounding		(1)	1
Return as in the RFS		**1,588**	**2,092**

The key differences are:

1. **The income statement and segmental analysis in the Annual Report separately identifies trading results before specific items.** Specific items are those that in management's judgement need to be disclosed by virtue of their size, nature or incidence. These are included in returns reported in the RFS.
2. **We allocate a share of costs where services are provided to, or shared by, Openreach from or with other parts of BT.** The RFS uses the methodologies directed by Ofcom and these differ from those adopted in the Annual Report.
3. **Ofcom directs that certain costs are treated as operating expenditure rather than capital expenditure in the RFS (relative to BT's accounting policies)**. These include GEA Customer Site installation, Tie Cables, GEA Cable Links, Abortive Visits, Co-mingling services, Excess Construction Charges and Expedite services, which are treated as operating expenditure in the RFS but are capitalised in the Annual Report.
4. **The RFS are prepared on a Current Cost Accounting (CCA) basis.** This differs from the Historical Cost Accounting (HCA) basis used in the Annual Report.

BT Group