

BT GROUP PLC
Form 6-K
May 27, 2011

**SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549**

**Form 6-K
Report of Foreign Private Issuer
Pursuant to Rule 13a-16 or 15d-16 of
the Securities Exchange Act 1934
Report on Form 6-K dated May 27, 2011**

BT Group plc

(Translation of registrant's name into English)

BT Centre
81 Newgate Street
London EC1A 7AJ
England

(Address of principal executive offices)

Indicate by check mark whether the registrant files or will file annual reports under cover of Form 20-F or Form 40-F.

Form 20-F Form 40-F

Indicate by check mark whether the registrant by furnishing the information contained in this Form is also thereby furnishing the information to the Commission pursuant to Rule 12g3-2(b) under the Securities Exchange Act of 1934.

Yes No

Enclosure: BT Group plc Annual Report & Form 20-F 2011 as sent to shareholders

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

BT Group plc

By: /s/ Vivienne Haynes

Name: Vivienne Haynes

Title: Director, Corporate Governance

Date: May 27, 2011

**Welcome to BT Group plc's
Annual Report & Form 20-F
2011**

**BT is one of the world's leading communications
services companies, serving the needs of
customers in the UK and in more than
170 countries worldwide.**

- 02** [Financial summary](#)
 - 03** [Chairman's message](#)
 - 04** [Our business](#)
 - 06** [Our strategy](#)
-

OVERVIEW
FINANCIAL SUMMARY
Group results

	2011	2010	Change
Revenue			
adjusted ^a	£20,076m	£20,911m	â4%
reported	£20,076m	£20,859m	â4%
EBITDA^{b,c}			
adjusted ^a	£5,886m	£5,639m	â4%
reported	£5,557m	£5,162m	â8%
Profit before taxation			
adjusted ^a	£2,083m	£1,735m	â20%
reported	£1,717m	£1,007m	â71%
Earnings per share			
adjusted ^a	21.0p	17.3p	â21%
reported	19.4p	13.3p	â46%
Proposed full year dividend			
	7.4p	6.9p	â7%
Free cash flow^{c,e}			
adjusted ^a	£2,223m	£2,106m	â£117m
reported	£2,011m	£1,933m	â£78m
Net debt^c			
	£8,816m	£9,283m	â£467m

How we performed in 2011

	Outlook May 2010	Result	
Revenue	c.£20bn	£20.1bn	ü
Operating cost^d savings	c.£900m	£1.1bn	ü

Adjusted EBITDA^{a,c}	in line with 2010 ^f	£5.9bn	ü
Adjusted free cash flow^{c,e}	c.£1.8bn ^f	£2.2bn	ü
Net debt^c	<£9bn	£8.8bn	ü

Outlook

We expect

Underlying revenue^g excluding transit to be in the range of down 2% to flat in 2012 and to grow by up to 2% in 2013

Adjusted EBITDA to grow in 2012 and to be above £6.0bn in 2013

Adjusted free cash flow to be above the 2011 level in both 2012 and 2013

^a Items presented as adjusted are stated before specific items. See page 56 for further details.

^b EBITDA: Earnings before interest, taxation, depreciation and amortisation.

^c Adjusted and reported EBITDA, adjusted and reported free cash flow and net debt are non-GAAP measures provided in addition to the disclosure requirements of IFRS. See page 56 for further details.

^d Operating costs before specific items, depreciation and amortisation. See page 48 for

further details.

^e Before pension deficit payments.

^f Adjusted EBITDA and adjusted free cash flow outlook updated in November 2010 to be around £5.8bn and £2bn, respectively.

^g Underlying revenue excludes the impact of foreign exchange movements, acquisitions and disposals and specific items.

2

OVERVIEW

CHAIRMAN'S MESSAGE

Last year we set out our plans for returning BT to growth in 2013. This year has been one of progress against these plans, but it has not been without challenges. Financially, however, we have delivered or exceeded our promises, improving both profitability and cash generation.

Dividends

As we stated in 2010, the Board is committed to progressive dividends over the period to 2013, while balancing the need to invest in the business, reduce our debt and support the pension fund. Taking these considerations into account, the Board is proposing a final dividend of 5.0p, giving a total dividend for the year of 7.4p, up 7% over last year.

BT's commitment to the UK

Broadband is a critical service for people and businesses in the UK. The Government aspires to seeing the UK become the best European country for broadband by 2015. BT is doing a great deal to make sure this aspiration becomes a reality. We start from a high base, with around 99% of UK premises already enjoying access to copper broadband, the best availability of all of the G8 countries. This year we extended our ADSL2+ copper broadband service, offering speeds of up to 20Mbps, to over 65% of UK premises.

We are also investing £2.5bn in our super-fast fibre-based broadband network. It already makes significantly enhanced speeds available to more than 4m premises, and we intend to extend this to two thirds of UK premises by the end of 2015. We aim to go further and bring fibre to homes and businesses in the final third of the UK, provided that investment and regulatory conditions remain favourable and that we are able to use funds made available by Government to support roll-out to rural areas. We are delighted to have taken part in winning tenders which are seeing fibre extended throughout Northern Ireland and Cornwall.

BT's networks are open to communications providers on wholesale terms. We continue to push for regulatory reform, so that, for example, we can purchase more TV and movie content at fair prices, just as pay TV providers can access our network at regulated prices.

Our investment represents just one aspect of our commitment to the UK economy, which we also support through employment and paying and collecting taxes of around £3bn per year.

BT's global presence

Across the world BT is investing to deliver excellent service to customers. We will continue to focus our investment next year on the Asia Pacific region, where many of our largest customers are looking to expand.

Internationally, we want regulation to level the playing field so that we can compete efficiently for the benefit of customers. We work for open and fair wholesale access to fixed and mobile telecoms networks to drive competition. We have seen some progress. In the US, the Federal Communications Commission has launched an investigation on access. In the EU, measures have been adopted that will offer greater regulatory consistency for fibre networks and internet policy. I was pleased that the EU and US Government recently agreed a series of pro-competitive regulatory principles to advocate globally.

BT's contribution to society

We strongly believe that to be a better business our corporate and social responsibilities must remain at the heart of what we do. So we have added being a responsible and sustainable business leader to our strategic priorities. Through our formal volunteering programme BT people have given a lot of time to community initiatives over the past year, with over 49,000 days volunteered. We are also participating in the UK's Work Inspiration campaign, led by Business in the Community, to help bridge the gap between the classroom and employment. We have a range of measures to limit BT's energy use and emissions. To help our customers reduce their impact on the environment we have launched a building energy management product in Spain, a smart grid offer in North America and a smart metering partnership in the UK.

We maintained gold sector status in the Dow Jones Sustainability Index and Platinum Plus level in the Business in the Community Corporate Responsibility Index.

I am personally committed to our agenda and chair the Board Committee for Sustainable & Responsible Business.

The Board and governance

I was delighted to welcome two outstanding non-executive directors to the Board this year. Nick Rose, joined us from Diageo, where he was previously finance director. He brings a wealth of experience in international operations. Jasmine Whitbread, chief executive of Save the Children International, also joined us. She has extensive experience of public companies and charitable organisations and a deep understanding of the importance of corporate responsibility in building a sustainable global business model.

There have been significant changes in the UK corporate governance arena this year. In response we have extended the remit of the Audit Committee to reflect an increased focus on risk; extended the remit of the Nominating Committee to include governance and compliance issues; and established five regional governance committees to assist the business in managing governance and risk internationally.

We welcome the new UK Corporate Governance Code. At the 2011 AGM, as well as Nick Rose and Jasmine Whitbread who will retire automatically and be proposed for election, all the other directors, with the exception of Clay Brendish, will be seeking re-election. Clay will be retiring as a non-executive director at the end of August after nine years as a member of the Board. Clay has been a great asset and we have particularly valued his IT industry experience. I would like to thank him for his contribution over so many years.

My thanks go to all the Board and the executive management for all their efforts during the year.

Our future

I am convinced that the focus and determination of the Board, management and our people will enable us to deliver our plans to make BT a better business with a better future.

Sir Michael Rake

Chairman

11 May 2011

OVERVIEW

OUR BUSINESS

Our main activities

BT is one of the world's leading communications services companies, serving the needs of customers in the UK and in more than 170 countries worldwide. Our main activities are the provision of fixed telephony lines and calls, broadband, mobile and TV products and services as well as managed networked IT services.

In the UK we are a leading communications services provider, selling products and services to consumers, small and medium-sized enterprises and the public sector. We also sell wholesale products and services to communications providers in the UK and around the world. Globally, we supply managed networked IT services to multinational corporations, domestic businesses and national and local government organisations.

2011 external revenue and adjusted EBITDA by line of business

Where we operate

Sustainability

We aim to carry out our business in a responsible and sustainable way. Increasingly, our customers, shareholders, suppliers and our people expect this from BT. The innovative solutions we develop will benefit both society and our long-term development.

[> More on page 36](#)

4

OVERVIEW OUR BUSINESS

Our business model

We believe that we have developed a sustainable business model capable of creating and delivering value for shareholders. We are confident that this model will allow BT to prosper in a changing world.

BT has four customer-facing lines of business: BT Global Services, BT Retail, BT Wholesale and Openreach. These are supported by two internal service units, BT Innovate & Design and BT Operate.

BT GROUP PLC			
BT GLOBAL SERVICES	BT RETAIL	BT WHOLESALE	OPENREACH
<p>BT Global Services is a managed networked IT services business, serving customers in more than 170 countries worldwide. > More on page 23</p>	<p>BT Retail provides communications products and services to the consumer market, and provides IT and communications services to small and medium-sized enterprises. > More on page 26</p>	<p>BT Wholesale provides products and services to over 1,000 communications providers in the UK. > More on page 30</p>	<p>Openreach is responsible for the last mile of the UK access network and for the roll-out of super-fast broadband. > More on page 33</p>
<p>Multinational corporations Domestic businesses National and local government organisations</p>	<p>UK consumers UK SMEs Republic of Ireland businesses, government and communications providers</p>	<p>UK communications providers Mobile operators Internet service providers Broadcasters</p>	<p>UK communications providers</p>
<p>Account management Online</p>	<p>Call centres Online Account management BT Local Businesses</p>	<p>Account management Online</p>	<p>Account management Online</p>
<p>Networked IT services Ethernet Fixed calls and lines Audio & videoconferencing Wi-fi & mobility Professional services / Wholesale network capacity</p>	<p>Fixed lines and calls Broadband TV services Wi-fi & mobility IT services Audio & videoconferencing</p>	<p>Wholesale network capacity Wholesale broadband Private circuits Ethernet Managed network services Content distribution services</p>	<p>Wholesale fixed lines Local Loop Unbundling Ethernet Physical infrastructure access</p>
BT INNOVATE & DESIGN AND BT OPERATE			
<p>BT Innovate & Design develops, designs and delivers the processes, networks and platforms on behalf of the customer-facing lines of business. > More on page 35</p>		<p>BT Operate manages BT's IT and network infrastructure platforms. > More on page 35</p>	

OVERVIEW

OUR STRATEGY

Our aim

Our aim is to drive shareholder value by making BT a better business with a better future.

Driving broadband-based consumer services

Being the Brand for Business for UK SMEs

BT Global Services a global leader

The wholesaler of choice

The best network provider

A responsible and sustainable business leader

<p>Our strategy starts with customer service. Our goal is to deliver excellent customer service as it is vital for our customers and reduces our costs when we get things right first time .</p>	<p>Improved customer service and reduced cost of failure along with other efficiency measures drive lower costs across our business.</p>	<p>Cost transformation frees up financial and other resources to allow us to invest in our networks, systems, and products and services to drive growth.</p>
<p>> More on page 11</p>	<p>> More on page 11</p>	<p>> More on page 11</p>

> More on page

10

Key performance indicators

We measure our overall progress by three key performance indicators:

Adjusted earnings per share

This is a measure of the overall profitability of our business.

>More on page 49

Reported free cash flow

This is a measure of the cash generated by our business that is available to invest in the business, reduce net debt, support the pension fund and pay dividends.

> More on page 50

Customer service improvement

This is a measure of the level of improvement in how we are serving our customers.

> More on page 10

^a Adjusted earnings per share is stated before specific items. See page 57 for further details.

^b Reported free cash flow is a non-GAAP measure. See page 58 for further details.

^c Cumulative improvement from 1 April 2007.

6

OVERVIEW OUR STRATEGY

Our strategic priorities

We will build a better future for BT through our six strategic priorities:

Driving broadband-based consumer services

The UK broadband market is one of the most dynamic and competitive in the world and we are confident we can continue to win in this market.

5.7m retail broadband customers, up 11%

144,000 BT Infinity customers

64% share of retail net DSL and LLU additions in the fourth quarter, highest for eight years

575,000 BT Vision customers

> More on page 11

The wholesaler of choice

We aim to be the wholesaler of choice in the UK and in the international wholesale telecoms services market.

Managed network services revenue up 8%

40% of external revenue under long-term contracts

Customers include the five main UK mobile operators and over 1,000 CP customers

> More on page 12

Being the Brand for Business for UK SMEs

We are the leading provider of fixed-line communications services for SMEs in the UK and we aim to be the Brand for Business for UK SMEs.

Improved trend in BT Business revenue

IT services revenue up 17%

Mobility revenue up 14%

> More on page 11

The best network provider

We are the UK's largest provider of fixed telephony lines and aim to be the best network provider in the UK. We are also rolling out a super-fast broadband network.

7.6m external unbundled lines, up 15%

1,000 fibre Ethernet nodes, the largest Ethernet network in the UK

Roll-out of super-fast fibre-based broadband on track to pass 5m UK premises by spring 2011

> More on page 12

BT Global Services a global leader

We are a global leader in managed networked IT services and we are working to build BT Global Services into a stronger business.

Operating cash flow positive a year ahead of plan

10% increase in order intake

Investing to grow in the Asia Pacific region

> More on page 12

A responsible and sustainable business leader

We believe that long-term profitable growth can be aided by supporting the communities in which we operate and through sustainable business practices.

Absolute carbon footprint down 53% since 1997

Money, time and in-kind contributions worth £27.6m invested

49,000 volunteer days

> More on page 13

<u>10</u>	<u>Who we are</u>
<u>10</u>	<u>What we do</u>
<u>10</u>	<u>Our aim</u>
<u>11</u>	<u>Our strategic priorities</u>
<u>13</u>	<u>How we measure our progress</u>
<u>14</u>	<u>UK consumers</u>
<u>15</u>	<u>UK SMEs</u>
<u>15</u>	<u>Global networked IT services</u>
<u>16</u>	<u>Wholesale</u>
<u>16</u>	<u>Access</u>
<u>17</u>	<u>Regulation</u>
<u>19</u>	<u>Brand and reputation</u>
<u>19</u>	<u>People</u>
<u>21</u>	<u>Networks and platforms</u>
<u>21</u>	<u>Global research capability</u>
<u>22</u>	<u>Suppliers</u>
<u>22</u>	<u>Property portfolio</u>

<u>23</u>	<u>BT Global Services</u>
<u>26</u>	<u>BT Retail</u>
<u>30</u>	<u>BT Wholesale</u>
<u>33</u>	<u>Openreach</u>
<u>35</u>	<u>BT Innovate & Design</u>
<u>35</u>	<u>BT Operate</u>
<u>36</u>	<u>Introduction</u>
<u>36</u>	<u>Building stronger communities</u>
<u>37</u>	<u>Reducing carbon emissions and our impact on the environment</u>
<u>38</u>	<u>Behaving responsibly</u>
<u>38</u>	<u>Our corporate responsibility risks</u>
<u>38</u>	<u>Further information</u>
<u>39</u>	<u>Our approach to managing risk</u>
<u>39</u>	<u>Principal risks and uncertainties</u>
<u>40</u>	<u>Our risks</u>

BUSINESS REVIEW

INTRODUCTION FROM THE CHIEF EXECUTIVE

A better business

BT has become a better business in the last year by staying focused on improving customer service and transforming costs, and by investing in the areas that we believe will deliver future growth. However, we still have much more to do in all these areas.

Our annual report will give you a good summary of the progress we're making and I'd like to share my thoughts on how we're doing in creating a better future for BT.

Financially, we now have a much stronger base. We've nearly trebled adjusted free cash flow in the last two years to over £2.2bn. We intend to build on this in the year ahead as we pursue our goal of growing the business whilst continuing to grow our profits and cash flow.

Delivering excellent customer service, right first time, is important for our customers and is a critical factor in helping to transform costs. We've made improvements in many areas, though this was masked by problems when a huge upsurge in demand for our engineers and very poor winter weather meant we didn't always deliver on our promises. While we are largely on top of things now, lessons have been learnt in making sure that we get better forecasts from our communications provider customers and by having a greater flexibility in our resourcing.

Improvements in our processes have helped drive efficiency with total operating costs reducing by over £1bn in the year. This has freed up financial and other resources which will allow us to invest in potential growth areas. While it's early days, there are positive signs that these investments are starting to pay off.

For example, Openreach's fibre broadband network roll-out is on track to pass 5m UK premises by spring 2011 well on our way to 10m premises by 2012. Thousands of customers are taking up super-fast fibre-based broadband every week and really like the service. The overall growth in the broadband market has also been the driver of customers seeking to be connected to fixed lines, with the number of copper lines increasing for the first time for many years.

Our BT Retail business grew its share of the broadband market. Our retail market share excluding cable was 36% in the year. This is important as broadband is increasingly the means of accessing a range of services including TV, education and entertainment. After a tough 18 months, BT Business is back on track, signing up small and medium-sized businesses to IT and mobility services.

BT Global Services reached a significant milestone becoming operating cash flow positive a year ahead of schedule.

Our investment in the Asia Pacific region where we are extending our presence to better serve multinational corporations based in Asia and expanding into Asia is going well. And our sales teams are signing important deals with new and existing customers building on our position as a global leader in managed networked IT services.

Our BT Wholesale business is successfully moving from being a traditional UK wholesale provider to one that's providing long-term managed network services and network outsourcing to the UK industry.

Communication is ever more at the centre of our customers' lives and businesses. The more they rely on it, the more they expect from BT and we are happy to step up to that challenge. BT is delivering better service and much improved financial results allowing us to invest in the UK and across the globe. We still have much to do, but we are making progress in building a better business with a better future for all our stakeholders.

Thank you for your support.

Ian Livingston

Chief Executive

11 May 2011

£2.2bn

Adjusted free cash flow

5m

UK premises passed by super-fast broadband by spring 2011

36%

BT's retail share of DSL and LLU broadband market

BUSINESS REVIEW

OUR BUSINESS AND STRATEGY

Who we are

What we do

Our aim

Our strategic priorities

How we measure our progress

No. 1

Provider of fixed telephony lines in the UK

3%

Improvement in customer service delivery measure

£1.1bn

Operating cost^a savings

£2.5bn

Potential investment in super-fast broadband network

Progress made against all our strategic priorities

This is the BT Annual Report for the year ended 31 March 2011. It complies with UK regulations and comprises part of the Annual Report on Form 20-F for the US Securities and Exchange Commission to meet US regulations. This Annual Report has been sent to shareholders who have elected to receive a copy. A separate summary financial statement & notice of meeting 2011 has been issued to shareholders who have elected to receive a shorter document. Both documents are available on the company's website, www.bt.com.

In this Annual Report, references to BT Group, BT, the group, the company, we or our are to BT Group plc (which includes the activities of British Telecommunications plc) and its subsidiaries and lines of business, internal service units, or any of them as the context may require.

References to a year are to the financial year ended 31 March of that year, e.g. 2011 refers to the year ended 31 March 2011, except in relation to our super-fast fibre-based broadband roll-out plans, which are based on calendar years, not financial years. Unless otherwise stated, all non financial statistics are at 31 March 2011 except BT Infinity customer numbers which are at 6 May 2011.

Please see cautionary statement regarding forward-looking statements on page 162.

Denotes corporate responsibility activities. Being a responsible and sustainable business is integral to the way we work. Our non financial key performance indicators measure our progress. These also include direct costs to BT related to our environmental and social performance, in line with the principles of the connected reporting framework.

^a Before specific items, depreciation and amortisation. See page 48 for details.

Who we are

BT is one of the world's leading communications services companies, serving the needs of customers in the UK and in more than 170 countries worldwide.

What we do

Our main activities are the provision of fixed telephony lines and calls, broadband, mobile and TV products and services as well as networked IT services.

In the UK we are a leading communications services provider. We sell products and services to consumers, small and medium-sized enterprises (SMEs) and the public sector. We also sell wholesale products and services to communications providers (CPs) in the UK and around the world. Globally, we supply managed networked IT services to multinational corporations, domestic businesses and national and local government organisations.

Our aim

Our aim is to drive shareholder value by making BT a better business with a better future. Last year we set out a three-year plan to achieve this aim. Our strategy focuses on three key areas – customer service delivery, cost transformation and investing for the future. These three areas are the building blocks for making BT a better business. The better we serve our customers, the less time and money we spend on fixing faults and by transforming our costs we create new opportunities for investment in our future. By investing in our strategic priorities we expect to deliver growth in 2013.

Customer service delivery

Our strategy starts with customer service and we continually work to improve the level of customer experience. In practice this means keeping our promises, being easy to contact and straightforward to deal with; it means keeping our customers informed and taking prompt action to put things right if they have cause to complain; above all it means trying to do things – right first time – .

Right first time – is our key measure for customer service. It measures how often we get things right the first time for our customers: this is important as failure increases our costs. In 2011 we achieved a 3% improvement in this measure which compares with a 10.5% improvement in 2010. This shows that we made further progress this year but the scale was less than in previous years due to a number of issues, particularly a large increase in provision volumes requiring engineer visits. These were up over 25% in the year. In addition, the very poor winter weather both increased repair demand and reduced our ability to deploy engineers effectively. In order to meet these challenges we recruited additional engineers and have now brought repair work in hand to the equivalent of a day and a half – s work. Provision lead times improved to an average of 10 days at the end of March 2011. We will learn from what went wrong and will work more closely with our CP customers to ensure that together we provide better volume forecasts and we have a more flexible resource that can meet peaks of demand more effectively.

We did make progress in a number of other areas. Call handling times for consumer sales improved by 19 seconds due to the introduction of Agent.com, a new system that allows our sales agents to process orders faster and more effectively. With the roll-out of a desktop help system, broadband consumer customers can now solve many problems without the need to call our service centres. Within BT Retail, our – one contact resolution – aims to deal with customer queries in one call. We saw the number of queries dealt with in one contact increase by 15% in BT Consumer and 9% in BT Business. Within BT Global Services – right first time – programme, we reduced customer faults by 11%. We believe the changes we have made, and will make in the next financial year, will deliver significantly improved service levels for our customers.

BUSINESS REVIEW OUR BUSINESS AND STRATEGY

Cost transformation

Cost transformation goes hand in hand with getting it right first time for customer service we have continued with our drive to improve operational efficiency across the business, from using IT systems more effectively and driving savings from suppliers, to streamlining internal processes and ways of working.

In 2011 we made good progress with our cost transformation activities, which have contributed to our operating costs savings of £1.1bn, representing a 7% decline in our operating cost base. This represents a cumulative reduction in our cost base of almost £2bn over the last two years. All of our lines of business and internal service units have made a contribution to the delivery of these savings. See **Financial review** **Transforming our cost base** on page 47 for further details.

Savings have been delivered from targeted cost reduction programmes which focus on:

- eliminating the cost of failure across the group

- an overhead value analysis programme, which provides a structured approach to reducing costs

- process re-engineering, which reviews processes end-to-end across the group to remove unnecessary steps.

These actions have allowed us to operate more efficiently and consequently reduce our costs while at the same time reducing failure in our processes which assist customer service.

We have also continued to review procurement arrangements with our major suppliers on a group-wide basis and have improved supply terms and service delivery.

As a result of increased efficiency across our operations we have continued to reduce our net labour costs, which were down 7%. As far as possible, we try to retain our permanent workforce through redeployment, retraining and in-sourcing work which has been previously performed by third parties. Around 4,000 people have been re-skilled and redeployed into roles within BT in 2011.

Investing for the future

By being more efficient in customer service and transforming our cost base we can provide services to our customers on a more competitive basis and improve our cash generation. This is critical as it creates the opportunity for us to invest in our strategic priorities as well as reduce our overall level of net debt, support the pension fund and pay dividends to shareholders.

In 2010 we set out five strategic priorities which are underpinned by our views of the markets we operate in. By focusing investment around these strategic priorities we believe we will build a better future for all our stakeholders.

In 2011 we added a new strategic priority which reflects our work to embed sustainability and corporate responsibility at the core of our business.

Our strategic priorities

Driving broadband-based consumer services

Competition in the UK consumer market is intense and customers demands are evolving. Around 99% of UK premises now have access to broadband and customers are increasingly buying their line and calls service together with broadband and TV. We already provide a comprehensive broadband service offering many features and offer attractively priced bundles of services.

During 2011 we made the following progress:

- we grew our retail broadband customer base to 5.7m, up 11%

- 144,000 customers now take our super-fast fibre-based broadband service, BT Infinity

- 79% of the total UK broadband market, including cable, is now delivered over the BT network, with our retail share at 29%

- our retail share of DSL and LLU net additions in the fourth quarter of 2011 was 64%, the highest share of quarterly net additions in eight years

BT Vision's customer base grew to 575,000.

Looking ahead, we are aiming to grow the number of services we provide customers by building on our position as the market leader in broadband. TV is a growth area for us and one that will benefit from the roll-out of super-fast broadband. On-demand TV is becoming more popular and TV services will become increasingly personalised and interactive. It is for those reasons that we are investing in content and delivery, improving the user-interface for BT Vision and participating in the YouView joint venture.

In addition, over the coming years we expect to see the emergence of a range of broadband-based consumer services, building on new and existing services. There will also be new opportunities in the entertainment and networked home space, such as energy usage management and home automation.

Our future plans for driving broadband-based consumer services include:

- continuing to offer attractive bundled voice, broadband and TV services

- enhancing our entertainment offering with services such as online gaming

- seeking new opportunities to differentiate our services, for example by using our wi-fi network.

Being the Brand for Business for UK SMEs

We are the leading provider of fixed-line communications services for SMEs in the UK and we are well-placed to grow our revenue from IT and mobility services. The market remains highly fragmented and we believe this provides us with further opportunities to become the main brand SMEs trust by providing a one-stop shop for all their communications needs, and will help us to increase our market share.

During 2011 we made the following progress:

- improved trends in BT Business compared with prior years, with revenue only marginally down in 2011

- IT services and mobility revenue grew by 17% and 14%, respectively.

Our opportunities for growth include selling new services to our existing customer base and helping customers migrate to cloud-based services, which allow customers to access IT services on a more flexible basis.

BUSINESS REVIEW OUR BUSINESS AND STRATEGY

Our future plans for becoming the Brand for Business for UK SMEs include:

- increasing the number of SME customers buying our services

- selling more IT services and mobility to our existing SME customers

- offering bundles which combine fixed and mobile communication and IT services.

BT Global Services a global leader

BT Global Services is already a global leader in the provision of managed networked IT services. Over the past year we have focused on improving the performance of the business by simplifying the portfolio, rationalising systems and networks, industrialising the process of bid management and exploiting standardisation and automation. We adopted an industry sector-based structure to help focus on customer needs in four global sectors: Banking & Financial Markets; Commerce; Consumer Packaged Goods; and Government & Health. We also invested in growth areas such as multi-protocol label switching (MPLS), Ethernet, unified communications, security, customer relationship management, mobility and cloud services. Last year we identified the Asia Pacific region as a target for investment and we are strengthening our ability to support new and existing customers in this growing market.

During 2011 we made the following progress:

- we delivered operating cash flow of £119m, a year ahead of target

- order intake was £7.3bn

- we invested to grow our presence in the Asia Pacific region

- we have been recognised as a leader, winning the award for Best Global Operator at the World Communication Awards 2010.

Our future plans include:

- building on our strong market position in managed networked IT services

- expanding further to serve our customers in fast-growing economies

- developing our relationships with our target customers, and improving their customer experience

- building and enhancing industry based solutions in key sectors

- making our operations more efficient

- generating around £200m of operating cash flow in 2012.

The wholesaler of choice

BT is committed to supplying CPs in the UK and overseas with vital communications infrastructure and services. While we are already the largest wholesaler in Europe, there are significant opportunities for us to win new business. We aim to be the wholesaler of choice in the UK, where we already have more than 1,000 CP customers, provide fixed-line services to the five key mobile operators and are the established partner for carriers. We also operate an international wholesale business, where we serve customers in over 170 countries.

During 2011 we made the following progress:

- our managed network services (MNS) revenue grew by 8%

- 40% of BT Wholesale's external revenue is now underpinned by long-term contracts

our second generation copper broadband service is available to over 65% of UK premises

we received the Best Wholesale Carrier award at the World Communication Awards 2010.

Our future plans for becoming the wholesaler of choice include:

increasing the proportion of revenue under long-term contract by selling new MNS contracts

making investments in Wholesale Broadband Connect, our second generation broadband service, which we plan to extend to cover around 80% of UK premises by December 2011

launching IP services that enable our CP customers to enter and exploit new and emerging markets

increasing capacity on our IP platforms to meet growing customer demand

continuing to evolve our next generation product portfolio for the global wholesale market.

The best network provider

BT is the largest provider of fixed telephony lines in the UK and through Openreach we manage the last mile of the UK access network. We offer access to this network to other CPs on an open and equal basis.

It is our aim to improve network reliability, extend our Ethernet footprint, continue our super-fast broadband roll-out and put in place systems improvements and transformation programmes to enhance our proposition, reduce our cost base and make it easier for CPs to do business with us.

During 2011 we made the following progress:

we rolled out our super-fast fibre-based broadband network to reach over 4m UK premises

we contributed to the growth of the broadband market in the UK by the provision of 7.6m external unbundled lines, up 15%

we extended our footprint to over 1,000 fibre Ethernet nodes, providing the largest Ethernet network in the UK

we commenced testing a 1Gbps service over fibre-to-the-premises.

Our £2.5bn investment in super-fast fibre-based broadband will make the UK one of the best connected countries in the world.

Our super-fast fibre roll-out plans are ambitious and we are working to pass two thirds of UK premises by the end of 2015. To deliver this we are installing 30,000 cabinets, connecting 200,000 distribution points, enabling over 1,000 exchanges and laying over 50,000km of fibre. We have developed and refined our systems and processes to enable us to deliver fibre faster and we are upgrading more than 250 cabinets and enabling on average around 80,000 premises each week to access fibre.

We also aim to bring fibre to homes and businesses in the final third of the UK, given the right investment and regulatory conditions and access to Government funds.

BUSINESS REVIEW OUR BUSINESS AND STRATEGY

We are planning to roll out two solutions as part of our super-fast broadband deployment:

fibre-to-the-cabinet (FTTC) where new fibre-optic cables link telephone exchanges to road-side cabinets and our copper lines are used to deliver super-fast broadband to premises

fibre-to-the-premises (FTTP) where new fibre-optic cables are deployed the whole way from the exchange to the premises.

We have deployed FTTC first and are on track to pass around 5m premises by spring 2011. Currently, we are conducting FTTP trials at a number of sites with speeds of up to 1Gbps and full commercial FTTP is expected to be launched in 2011.

We see the Government's creation of Broadband Delivery UK (BDUK) as a positive step in providing services to the final third of premises in rural areas of the country where it is not currently economic to provide super-fast broadband services. We are committed to exploring ways to extend the footprint of super-fast broadband, and our deployments in Cornwall and Northern Ireland demonstrate that commitment.

All parts of the business play a role in the delivery of super-fast broadband:

Openreach is building the fibre access infrastructure which will offer super-fast broadband to all CPs on an open and equal basis

BT Wholesale is developing products and services which use the Openreach network so it can offer managed super-fast broadband to its CP customers

BT Retail and BT Global Services will purchase the BT Wholesale offer and design their own propositions and services for end users, for instance BT Infinity

BT Innovate & Design and BT Operate both play a key role in leading the design, development and end-to-end testing of the platforms, systems and products that will underpin our propositions for customers.

Through Openreach we have continued to invest in our market-leading UK Ethernet footprint. Ethernet is a data service primarily used by businesses to create their own private networks and can run over copper or fibre.

Being the best network provider is not just about expanding coverage. Openreach has made substantial progress in improving the copper access network in recent years. Network resilience has been improved through an extensive programme of work, accompanied by efficiency gains with regard to provision and repair times. As a result of these efforts, customers now experience a copper line fault once in every 14 years compared with once in every nine years as experienced four years ago.

Our future plans for becoming the best network provider include:

continuing with our super-fast broadband roll-out

providing new access products such as duct and pole access

improving our overall efficiency while improving the resilience and reliability of our networks

increasing our potential FTTC speeds to up to 80Mbps.

A responsible and sustainable business leader

We believe that long-term profitable growth can be aided by supporting the communities in which we operate and through sustainable business practices. We are committed to contributing positively to society, the economy and the environment through our operations, our employees and our products and services. We aim to provide products and services which enable our customers to be more sustainable by making use of innovative communication and managed networked IT services.

Even though this is a new strategic priority, we are already recognised as a responsible and sustainable business leader. For example we have:

cut our absolute carbon footprint by 53% since 1997 and reduced energy consumption by 2.5% in 2011

invested money and in-kind contributions worth £27.6m supporting responsible and sustainable business activities, exceeding our commitment to invest at least 1% of group pre-tax profits

launched a new online fundraising service for UK charities called MyDonate, the first online fundraising service not to charge a subscription fee or commission

maintained gold sector status in the Dow Jones Sustainability Index and Platinum Plus level in the Business in the Community Corporate Responsibility Index. We also won awards such as the World Communication Award Green Award .

More details of our corporate responsibility activities can be found at **Our corporate responsibility** on page 36.

An increasing number of customers are seeking to source from suppliers that can demonstrate a strong track record in improving the sustainability of their own businesses. Our credentials as a responsible and sustainable business leader support our ability to win and retain customers. We also plan to contribute in many other ways through the responsible use of resources; through our employment; and through our community involvement. Our drive for BT to be a better business with a better future is therefore linked to our commitment to be a leader in corporate responsibility and sustainability.

Our future plans for maintaining and enhancing our position as a responsible and sustainable business leader include:

- building stronger communities through the power of our technology and people

- reducing carbon emissions and our impact on the environment through our operations and products

- behaving responsibly towards our customers, people and our suppliers

- promoting MyDonate for the benefit of charities and fundraising.

How we measure our progress

We measure our overall progress by three key performance indicators: adjusted earnings per share, reported free cash flow and customer service improvement (see **Our strategy** **Key performance indicators** on page 6).

BUSINESS REVIEW

OUR MARKETS AND CUSTOMERS

UK consumers

UK SMEs

Global networked IT services

Wholesale

Access

Regulation

51%

BT's share of the UK fixed-line market

c.£5.7bn

Value of UK pay TV market

c.£29bn

Amount UK SMEs spend on IT and communications services

US\$584bn^a

Value of global IT services market

^a IDC Global IT services Market size. Source Worldwide Black Book Q1, 2011.

We compete in a number of markets including the consumer and SME markets in the UK and delivering managed networked IT services globally. We also offer a range of wholesale and access products and services to CPs, both in the UK and internationally.

In the UK, regulation and the open, commercial marketplace have created one of the most competitive telecoms markets in the world. Some of the products and services we offer in the UK are regulated because of our significant market power in some sectors. See **Regulation** on page 17 for more information. We also offer access services on an open and equal basis to all CPs.

UK consumers

The consumer fixed-line telecoms market in the UK is highly competitive, with more than 160 companies offering broadband and/or voice services. Although total UK residential fixed-line call minutes have declined 18% over the past three years, the total number of UK residential lines is up 2% over this period according to Ofcom data. The decline in fixed-line call minutes can be attributed to factors such as consumers increasingly using mobile phones rather than fixed-line phones, while the continued growth in fixed-line broadband has helped slow the decline in the number of residential lines.

BT is the leading provider of fixed-line voice and broadband services in the UK consumer market. We provide consumers with a range of services including fixed-line voice, broadband and TV products and services. We also provide directory services – both in print and via directory enquiries – and sell telephones and computer equipment through our online retail presences.

BT's share of the fixed-line market has declined from 69% to 51% over the past three years, reflecting the competitive nature of the market and continued growth in local loop unbundling (LLU). The share of the fixed-line market provided by cable has remained flat at 18% over the same period.

An important change in the consumer market occurred when regulation was modified to allow us to sell our products and services in bundles to customers for one price. This has allowed us to compete with other providers in offering attractive bundles: 40% of UK consumers currently buy triple-play services of broadband, pay TV and fixed-line telephony.

We sell our services to consumers online directly and via selected affiliates and through our call centres. We also advertise across a range of media including TV and social media, such as Facebook. More information about our products and services for UK consumers can be found in **BT Retail** on page 26.

The UK broadband market is highly competitive. Following a period of industry consolidation, our main competitors are Virgin Media, TalkTalk Group and Sky. Between us we account for 87% of the broadband market.

14

BUSINESS REVIEW OUR MARKETS AND CUSTOMERS

The UK consumer broadband market has grown to reach more than 17.7m households. BT has contributed to this growth by supplying LLU over which suppliers can deliver broadband services. The UK is now the sixth largest broadband market in the world by number of households.

Broadband penetration has increased year-on-year and the fixed broadband penetration rate now exceeds 65%. This has been driven by the increasing use of the internet by consumers. The number of adults accessing the internet every day has increased 42% over the past three years.

We believe that fixed broadband will remain most popular with customers and mobile broadband will be largely complementary. The increasing importance of broadband-enabled services in our daily lives and initiatives such as the Government sponsored Race Online 2012 have contributed to continued growth in the broadband market.

Pay TV services remain popular with customers and this sector continues to grow in size. The UK pay TV market is estimated at around £5.7bn and has increased by over 30% in the past three years. Customers value the convenience of internet-based TV content. Ofcom data shows that 31% of internet-enabled households watched catch-up TV online, up from 23% a year earlier.

There are a number of companies in the UK market supplying pay TV, video-on demand, and catch-up TV services. YouView, the joint venture between the BBC, ITV, Channel 4, BT and others is expected to be launched in calendar year 2012 and will make a significant contribution to the UK TV market.

Consumers are increasingly demanding more ethical and environmentally-friendly business practices from their suppliers. A growing number of customers want to buy services which will allow them to improve their own sustainability performance by improving efficiency and reducing emissions. We have met this demand by developing products such as our Home Hub 3 which uses 39% less power than previous models.

UK SMEs

The overall SME market in the UK is estimated as having 4.8m customers with spend on IT, broadband and network services estimated at about £29bn. Competition to supply services to SME customers remains fragmented, with many of our competitors typically focusing on specific segments of the market depending on customer size, focus and geography. Our competitors include companies focused on providing services to SMEs such as Daisy and Opal, larger companies such as Virgin Media and Cable & Wireless Worldwide, and mobile operators and IT services companies such as Phoenix IT and Computacenter.

We are the leading provider of fixed-line communications services for SMEs in the UK market. Our share of the fixed-line market is 52% and we have around 1m SME customers, characterised by their diversity. They range from start-ups and microbusinesses with fewer than 10 employees to medium-sized business with up to 1,000 employees. The recession has had an impact on SMEs' spending levels with the markets for fixed-line voice and data, mobile services and IT services all declining since 2008. IT services spend is expected to resume growth in calendar year 2011, while we expect the fixed-line voice and data market to continue to decline, driven in part by the significant fall in fixed-line business call minutes. A positive trend in the market is SME customers' increasing preference to buy bundled services, comprising fixed lines, mobile and broadband.

Source: GfKNOP on behalf of BT. Survey of SMEs with fixed-line, broadband and mobile. Agreement with statement your organisation prefers to buy complete Comms/IT products in combined package with score 1 to 10.

Calendar year 2010 saw a modest recovery in the economy with GDP growth becoming positive after shrinking 3.5% the previous year, but conditions for SMEs remain challenging. We have seen a 14% reduction in the 2010 calendar year in the number of companies going into liquidation, but levels remain above historical trends.

Global networked IT services

The global market for networked IT services is fragmented with a wide range of products and services and with many different competitors, from large IT corporations and network-based vendors, such as BT, through to niche technology suppliers.

Estimates of industry size and growth trends vary. The global IT services market is estimated to have a value of US\$584bn^a. After several years of relatively flat spend on IT services due to economic conditions, many industry analysts are forecasting higher rates of growth for 2012.

Source: IDC Market Model 2010. Forecast includes 1P VPN, Ethernet, Network management, Applications Visibility, Control & Optimisation and Managed Security for multinationals over 1,000 employees.

^a IDC Global IT services Market size. Source Worldwide Black Book Q1, 2011.

BUSINESS REVIEW OUR MARKETS AND CUSTOMERS

Demand for network based IT services continues to evolve with customers increasingly seeking to unify their communications (where an organisation's infrastructure, mobility, desktop and applications work together more effectively). They are also looking to virtualise their infrastructure (virtualisation or cloud services where customers business applications can be provided across BT's network rather than from their own premises, for example virtual data or contact centre solutions). They continue to want their networked IT services delivered securely, efficiently and globally.

Increasingly, our customers are asking us to help them capture the opportunities in a recovering economy, as well as reducing costs and improving efficiency in their businesses. In addition to helping customers reduce their capital expenditure, virtualised services, such as virtual data centres also provide energy savings.

We are a global leader in the networked IT services market with around 7,000 large corporate and public sector customers.

We supply networked IT services to national and local government organisations and other public sector bodies around the world. We are one of the largest suppliers of networked IT services for the UK Government. The UK Government, collectively, is BT's largest customer, but the provision of services to any one of its departments or agencies does not comprise a material proportion of our revenue. Except as described in **Our relationship with HM Government** on page 18, the commercial relationship between BT as a supplier and the UK Government as a customer is on a normal customer and supplier basis.

We are also seeing customers maintaining a focus on energy efficiency, ethical supply chain and other components of responsible and sustainable business practices. Through BT Conferencing we are a leading supplier of videoconferencing services globally and we have seen growing demand for videoconferencing, a service which helps both to drive business efficiency and limit emissions by reducing travel.

Wholesale

BT operates in wholesale markets in the UK through BT Wholesale and Openreach, and outside of the UK primarily through the wholesale arm of BT Global Services. BT's wholesale customers are fixed and mobile operators, internet service providers (ISPs), broadcasters and other CPs. We have over 1,000 such customers in the UK and many more around the world.

Source: Ovum

The landscape for wholesale communications remains competitive following the significant market consolidation of recent years. Competition continues to increase as a result of wholesale carriers rolling out their own IP network infrastructure and the switch from legacy to next generation products. Our competitors in the UK include Cable & Wireless Worldwide, TalkTalk Group, Virgin Media and COLT, as well as a range of equipment vendors. Many of these competitors are also customers. Internationally, we compete with the wholesale divisions of local incumbents and alternative network operators as well as global wholesale players.

The wholesale market is beginning to adopt next generation communications services like IP voice, higher speed broadband over copper and fibre and Ethernet for data connectivity. We have seen continued bandwidth growth with capacity more than trebling on our network over the past five years. To support the rapid growth of high bandwidth services such as video over fixed lines and mobile networks, a number of service providers are buying wholesale managed services to meet this demand quickly rather than building their own infrastructure.

Bandwidth consumed measured in gigabits and rebased to April 2006 = 100

We expect the sale of wholesale managed network services to continue to grow in line with developments in services like fixed and mobile broadband and internet-based TV.

In the UK, Ofcom regulates some of our wholesale broadband products based on geographic markets: in Market Three, which contains the most competitive exchanges (mainly urban areas) our wholesale broadband products are not regulated; in Market Two where there is some competition (mainly suburban areas), and in Market One where there is very little or no competition (mainly rural areas), our products are regulated.

Access

In the UK, we manage the last mile of the access network – the copper wires and fibre connecting homes and businesses to their local telephone exchange – through Openreach. We offer wholesale access products and services on an open and equal basis to CPs so that they can offer voice and broadband services to their own end customers.

The competitive challenge we face in the UK access market varies according to geography. We face direct competition in urban and metropolitan areas with some competition in rural areas. We also face competition from cable and mobile across our footprint.

We supply a range of access products directly to large and small CPs. This includes products such as LLU (which enables CPs to lease the local loop infrastructure from Openreach to offer voice and broadband to their own customers), Wholesale Line Rental (WLR) and Ethernet products. Under new obligations, we will also be offering products which give greater access to our underlying network infrastructure such as access to ducts and poles.

BUSINESS REVIEW OUR MARKETS AND CUSTOMERS

In the traditional fixed-line access market, we continue to see a steady rise in the number of households in unbundled exchange areas, which over the last three years has risen by around 5%.

In the UK local access market, the roll-out of BT's super-fast broadband network will improve the services available to customers. Other companies have also embarked on rolling out high-bandwidth broadband networks, making this a competitive sector. Demand for high bandwidth Ethernet access services also continued to grow.

We also provide backhaul services for mobile voice and data. We expect to see more demand for these services with the increasing use of smartphones and tablet devices. We believe that this market will continue to develop in the coming years with the roll-out of next generation access networks and high bandwidth applications.

Regulation

Regulation in the UK

Electronic communications regulation in the UK is conducted within a framework set out in various EU directives, regulations and recommendations. The framework has been reviewed and amended directives are expected to be implemented by late May 2011 in the UK and other EU member states.

Ofcom

Ofcom was set up under the Office of Communications Act 2002 to provide a single, seamless approach to regulating the entire UK communications market. Its principal duties are to further the interests of citizens in relation to communications matters, and to further the interests of consumers in relevant markets, where appropriate by promoting competition. Ofcom regulation takes the form of sets of conditions laid down under the Communications Act 2003 (Communications Act) and directions under these conditions. Some conditions apply to all providers of electronic communications networks and services; others apply to individual providers, which Ofcom has designated as universal service providers or as having significant market power (SMP) in a particular market.

Conditions applying to all providers

Although these general conditions are concerned mainly with consumer protection, they also include requirements relating to general access and interconnection; standards; emergency planning; the payment of administrative charges; the provision of information to Ofcom; and numbering. A separate condition regulates the provision of premium rate services. The Electronic Communications Code applies to all CPs authorised to carry out streetworks and similar activities for network provision.

Conditions applying to BT

Universal service obligations (USO) are defined in an order issued by the Secretary of State. BT is the designated supplier of universal service for the UK, excluding the Hull area where KCOM Group is the designated provider. Our primary obligation is to ensure that basic fixed-line services are available at an affordable price to all citizens and consumers in the UK. Other conditions relate to payphones and social needs schemes. The UK Government's plans for the digital economy have created a fund of up to £830m that is available via competitive tender to bidders in order to deliver the Government's ambition for rural next generation access. This is not part of BT's USO, but BT is likely to be one of the providers eligible to bid for such funds.

Significant market power designations

Ofcom is also required by EU directives to review relevant markets regularly, and determine whether any CP has SMP in those markets. Where Ofcom finds that a provider has SMP, it must impose appropriate remedies that may include price controls. In 2011 Ofcom completed market reviews of the Wholesale Local Access (WLA), Wholesale Broadband Access (WBA), WLR, and ISDN30 markets, covering products such as LLU and IPstream. Ofcom's WLA review conclusions include new obligations on BT to provide a fibre-based Virtual Unbundled Local Access (VULA) product and an obligation to share our ducts and poles for fibre-based broadband purposes.

In the WBA market, Ofcom increased the size of the mainly urban deregulated geographic market (Market Three), and introduced a price regulation obligation in the rural areas (Market One) subject to further consultation on appropriate charge controls (see SMP charge controls below). Ofcom has deregulated the ISDN30 market at the retail level and proposed charge controls at wholesale level subject to further consultation (see SMP charge controls below). Later in the 2011 calendar year, Ofcom is expected to begin a market review of the business connectivity markets covering products such as retail and wholesale leased lines.

SMP charge controls

As a result of SMP designations, the charges we can make for a number of wholesale services are subject to regulatory controls which are designed to ensure that our charges are reasonably derived from costs, plus an appropriate return on capital employed.

These include:

network charge controls (NCC) on wholesale interconnect services we operate under interconnection agreements with most other CPs

partial private circuits (PPC) charge controls applying to certain wholesale leased lines that BT provides to other network operators

certain wholesale Ethernet access and backhaul services

LLU and WLR.

BUSINESS REVIEW OUR MARKETS AND CUSTOMERS

Ofcom is currently consulting on charge controls for WBA Market One, LLU, WLR and ISDN30 Wholesale products. Ofcom has imposed SMP charge control regulation on the mobile call termination market with effect from April 2011. Termination rates charged by mobile network operators will fall to 0.69 pence per minute by April 2014. This will enable us to lower the cost of calling mobiles from fixed lines.

Regulatory decisions by Ofcom are subject to appeal.

BT's Undertakings

In response to Ofcom's 2005 strategic review of telecommunications, we proposed a number of legally-binding Undertakings under the Enterprise Act 2002 (Enterprise Act). These Undertakings, which included the creation of Openreach, were accepted by Ofcom and came into force in September 2005. The Undertakings are intended to deliver clarity and certainty to the UK telecommunications industry about the way BT will provide upstream regulated products to support effective and fair competition in related downstream markets. Ofcom acknowledges that BT's delivery of the Undertakings has enabled deregulation in more competitive downstream markets. The vast majority of the commitments in the Undertakings have been delivered.

Business rates

The European Commission formally investigated the way the UK Government set the rates payable on BT's infrastructure and those paid by KCOM, and whether or not the UK Government complied with EU rules on state aid. The Commission's decision in October 2006 that no state aid had been granted was appealed. In January 2011, the appeal was rejected as inadmissible.

Our relationship with HM Government

We can be required by law to do certain things and provide certain services for the UK Government. For example, under the Communications Act, we (and others) can be required to make and implement plans for the provision or restoration of services in connection with disasters. Additionally, under the Civil Contingencies Act 2004, the UK Government can impose obligations on us (and others) at times of emergency and in connection with civil contingency planning. Also, the Secretary of State can require us to take certain actions in the interest of national security and international relations.

Regulation outside the UK

BT must comply with the regulatory regimes in the countries in which we operate and this can have a material impact on our business.

European Union

Communications regulation in each EU country is conducted within the regulatory framework determined by EU directives, regulations and recommendations. The manner and speed with which the existing directives have been implemented vary from country to country. National regulators are working together in the Body of European Regulators for Electronic Communications to introduce greater harmonisation in their approach to the assessment of SMP and the imposition of appropriate remedies.

The rest of the world

The vast majority of the communications markets in which we operate around the world are subject to regulation. The degree to which these markets are liberalised varies widely, and our ability to compete is constrained, to a greater or lesser degree, in many countries. We continue to press incumbent operators and their national regulatory authorities around the world (including in the EU) for cost-related non discriminatory wholesale access to their networks, where appropriate, and for advance notice of any changes to their network design or technology which would have an impact on our ability to serve our customers.

Competition law

In addition to communications industry-specific regulation, BT is subject to the Competition Act 1998 in the UK and to EU competition law.

BUSINESS REVIEW

OUR RESOURCES

Brand and reputation

People

Networks and platforms

Global research capability

Suppliers

Property portfolio

92,600

People worldwide

(full-time equivalent employees)

c.120m km

Length of copper cable on our network

£684m

Investment in global research and development

16,700

Suppliers

8,400

Properties worldwide

BT's resources include our people, physical networks and property estate; our expertise and intellectual property; our brand and reputation; and close relationships with people and organisations, including major customers and suppliers. We seek to steward these assets and relationships in a responsible and sustainable manner. We strive to recruit and retain talented people, so that the company can best serve its customers, build relationships, remain innovative and reduce its impact on the physical environment. We are investing to enhance our resources in the long-term interests of the company and all its stakeholders. For example, as described elsewhere in this report, we are committing £2.5bn to build a super-fast broadband network in the UK, while expanding activities outside the UK, with a particular focus on the Asia Pacific region. We continue the innovation which is vital to any company in our sector – we filed 62 patent applications over the past year.

Brand and reputation

When we develop our relationships with customers, when we make innovative and useful products, we build our reputation. BT is proud to be one of the UK's most trusted brands – our latest research shows that consumers engagement with our brand has gone up 4.5% over the past year. Being a responsible and sustainable business leader contributes to this.

Our brand values underpin how we like to get things done at BT. They outline the behaviour our employees can expect from each other and what our customers can expect from us.

trustworthy: we do what we say we will

helpful: we work as one team

inspiring: we create new possibilities

straightforward: we make things clear

heart: we believe in what we do.

As the official communications partner to the London 2012 Olympic Games and Paralympic Games, we are providing the critical communications infrastructure to power the Games. The partnership is already delivering real benefits and it is also helping us to engage with local communities. Six out of 10 BT people who were surveyed as part of our annual employee survey say the partnership makes them feel proud to work here.

As well as the Games themselves, the BT Paralympic World Cup in Manchester in May 2011 is in its second successful year. Our Road to 2012 project with the National Portrait Gallery celebrates those who are collectively making the Games happen.

People

Our people are a key resource and we are proud of what they achieve for our business. We continually work on improving the engagement and motivation of our people as this leads to better business performance and higher levels of customer service.

We recognise the quality of our leadership is vital to the success of BT. We ensure leaders at all levels understand what is expected of them in leading and developing their teams.

Part of valuing our people is to recognise our responsibility when the requirement for various skills changes over time. We have a successful track record of redeploying people by helping them learn new skills and find jobs within BT's growth areas or while seconded to another organisation.

We have people on different types of working arrangements including part-time, term-time and job share. Our resources at 31 March 2011 were equivalent to 75,660 full-time employees in the UK, and around 16,940 outside the UK.

BUSINESS REVIEW OUR RESOURCES

We continue to support an inclusive working environment where people can develop their careers and expect to be treated fairly, regardless of their race, sex, religion/beliefs, disability, marital or civil partnership status, age, sexual orientation, gender or caring responsibilities. We also work with specialist recruitment agencies to enable the recruitment of people with disabilities and we run a retention service to ensure that people can stay with us even if their capabilities change.

Diversity of the BT workforce

Target 2012	2011	2010	2009
BT will maintain a top 10 position in four of five major diversity benchmarks; four UK based, and one global			

We look to improve customers' experiences of BT by giving our people the up-to-date skills, tools and experience needed to do their jobs. This starts with our nationally-recognised apprentice schemes, which recruited nearly 500 engineers during 2011, and continues with opportunities to learn and develop throughout an employee's career. In BT Retail, we ran two programmes to provide apprentice qualifications in job-related skills: customer service and business administration for our advisors and leadership for our managers. During the year 8,100 people successfully completed these qualifications.

In order to help deliver super-fast broadband, Openreach has recruited 200 ex-armed forces personnel, who will become part of a mobile engineering workforce. They will be bringing their experience of complex engineering tasks, their skills and technical expertise to bear on one of the UK's largest infrastructure projects.

BT people are also encouraged to participate in their local communities. We run a formal volunteering programme to help them do this. In 2011 BT people volunteered over 49,000 days, the value of which we estimate at £13.8m. The community benefits from this involvement and the business gains from the opportunity given to our people to enhance their existing skills or acquire new ones.

People engagement and communication

Keeping our people informed of what is happening in BT is important. We use a range of communications channels including a daily online news service, a quarterly magazine, podcasts and web chats. We have a record of stable industrial relations and constructive relationships with the recognised unions in the UK and works councils elsewhere in Europe. In the UK we recognise two main trade unions – the Communication Workers Union (CWU), which represents the engineering, administrative and clerical population and Prospect, which represents managerial and professional employees. We also operate a pan-European works council, the BT European Consultation Committee. We measure how engaged BT people are through a quarterly survey and we ask 50,000 people each time to tell us how they feel about their job, their team, their manager, senior leaders and BT. Last year, despite challenging economic conditions, we held engagement steady. This year we have seen improvements in how motivated people feel to do their best work. We use this regular and extensive feedback to let line managers know more about their teams, how engaged they feel and what makes BT people feel proud about what they do.

Reward and recognition

Because we value our people, we ensure that the reward they receive is fair for the job done against external market comparisons. We conduct a market review of salaries every year. In 2010 we agreed with the CWU a three-year pay deal which provides considerable stability for both employees and the business. Discussions with Prospect reached an agreement for 2011 and more recent discussions have concluded a further two-year pay deal, also providing stability through to 2013. The same principles of fair pay for the work done are similarly applied in all other countries in which

we operate.

Our managers are rewarded with bonuses linked to the success of the business and their personal contribution to it. Our most senior managers are also eligible for long-term incentives, but again, payment is related to business success measured by BT's corporate performance over a three-year period. For more information see the **Report on directors remuneration** on page 69. Different arrangements apply to the most senior managers in Openreach but remain entirely related to business performance.

We also provide savings-related share option plans in 25 countries. Under the BT employee share investment plan we enable employees in the UK to participate in a tax and national insurance-efficient share purchase scheme. We are pleased that more than 50% of BT people participate in one or more of these share plans.

Pensions

Key parts of the reward package are the pension and retirement benefits for our people. In addition to statutory retirement arrangements, BT provides retirement plans for staff in over 50 countries. The largest of these plans is the BT Pension Scheme (BTPS), a defined benefit plan in the UK. The BTPS has around 51,000 contributing members, 188,000 pensioners and 88,500 deferred members. The BTPS was closed to new members on 31 March 2001. Benefits are based on pensionable salary and service.

We also offer the BT Retirement Saving Scheme (BTRSS), a defined contribution plan for eligible UK employees, which has around 17,500 active members. It is a contract based, defined contribution arrangement provided by Standard Life, a leading UK insurance company. The scheme members receive benefits at retirement linked to contributions paid, the performance of each individual's chosen investments and the annuity rates at retirement.

BUSINESS REVIEW OUR RESOURCES

Health and safety

The health and safety of our people remains of paramount importance and we continue to seek improvements by focusing on behavioural and/or lifestyle changes to reduce risk and improve health. Details of time lost to injury and sickness and their cost to BT are shown in the table below. The rise in lost time injuries is largely attributable to accidents associated with the extended period of ice and snow in the UK winter and some contribution from an increased overtime requirement in the field engineering workforce.

Lost time injury rate lost time injury cases expressed as a rate per 100,000 hours worked on a 12-month rolling average

Non financial performance

Target 2012	2011	2010	2009
Reduce to 0.200 cases	0.225	0.209	0.160

Financial performance

Cost to the business arising from injuries resulting in time off work	£6.1m	£5.6m	£7.0m
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Sickness absence rate percentage of calendar days lost to sickness absence expressed as a 12-month rolling average

Non financial performance

Target 2012	2011	2010	2009
Reduce to 2.29%	2.41%	2.46%	2.17%

Financial performance

BT sick pay costs	£90.1m	£95.4m	£85.2m
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Networks and platforms

One of our most valuable resources is our fixed-line communications network, which is the most comprehensive in the UK with around 5,600 exchange areas, 670 local and 120 trunk processor units.

We own and maintain the 'last mile' of the UK's local access network – the copper wires and fibre connecting homes and businesses to the core network – operating approximately 120m kilometres of copper. In addition, our plans for deploying super-fast broadband in the UK will result in the installation of over 50,000 Kilometres of fibre.

BT continues to invest in broadband in the UK, offering a range of services delivered over copper and fibre. Our copper wire broadband service offers speeds of up to 8Mbps (ADSL) and up to 20Mbps where we have upgraded service to ADSL2+. Already, around 99% of UK premises can receive ADSL service. We aim to make ADSL2+ services available to around 80% of properties by December 2011.

Our super-fast fibre-based broadband offers speeds of up to 40Mbps (FTTC) and 100Mbps (FTTP). We aim to deploy super-fast broadband to two thirds of UK premises by the end of 2015. Our FTTC product links roadside cabinets to telephone exchanges and our copper local loop is used to deliver super-fast broadband to customer premises. FTTP

involves installing fibre into homes or premises, superseding the copper local loop. Our fibre services are competition ready from the day they are installed – other CPs can buy access to the fibre on wholesale terms and then sell to customers in competition with BT Retail.

BT's deployment of FTTC and FTTP will underpin the communications infrastructure for the future UK economy. In so doing, the enhanced internet speeds made possible by super-fast fibre-based broadband increase the ability of our customers to work from home and access services without travel, yielding environmental benefits. In addition to facilitating lower carbon alternatives for customers, we continue to look for ways to reduce the energy consumption associated with delivering super-fast broadband.

For business customers, we have also continued to extend our fibre Ethernet footprint, from 600 nodes in 2009 to 1,000 nodes in 2011. Ethernet is a next generation data connectivity service offering high-speed, lower cost connectivity for large volumes of data between sites.

For non-domestic customers requiring international services, our international MPLS network provides coverage and support around the world. It provides the performance, reliability, and security of a leased-line network with the scalability and flexibility of an internet protocol (IP) network. The BT MPLS service allows customers to prioritise traffic based on application, ensuring essential data applications are served irrespective of the growth of competing, lower priority traffic.

Global research capability

Creating attractive and competitive propositions for customers is critical to the future of BT. We operate an open innovation model, whereby our research and development team works with customers, partners and universities around the world. They do so in partnership with our dedicated innovation scanning teams in the US, Asia, Europe and the Middle East, which identified more than 400 new technologies, business propositions and market trends over the year.

BT also seeks to drive agility and efficiency in the development process through our global development centres, which are located in the UK, US, Europe and India. In so doing, we bring our innovation scanning and research teams closer to our customers, designers and product development teams, so that we can quickly capitalise on the opportunities they uncover. In 2011 we invested £684m (2010: £789m) in global research and development to support our drive for innovation. This investment comprised capitalised software development costs of £295m (2010: £345m) and research and development operating costs of £389m (2010: £444m).

This year, we have applied our research and innovation capability to a number of strategic areas for the business – in particular enhancing BT Vision and the delivery of other information and entertainment to customers. We have also supported BT's wi-fi service with the development of BT's first smartphone application. In 2011 we filed patent applications for 62 inventions (2010: 63). We routinely seek patent protection in different countries including the US and China, and we currently maintain a total worldwide portfolio of around 5,600 patents and applications.

BUSINESS REVIEW OUR RESOURCES**Suppliers**

BT works with around 16,700 suppliers across the world, spending approximately £11.3bn per annum with them, with the top 100 suppliers accounting for more than 65% of this spend.

We source products and services from across the world and have procurement professionals located in 25 countries.

We operate a strategic sourcing process for the vast majority of spend to derive maximum value and to meet BT's cost transformation goals. We ensure that appropriate suppliers are engaged, underpinned by a set of purchasing principles which ensure we act in an ethically and commercially responsible way in our business dealings with our global supply base.

We work with our suppliers to ensure the goods and services we procure are made, delivered and disposed of in a socially and environmentally-responsible manner. Sustainability factors such as energy usage, environmental impact, and labour standards are embedded in our sourcing and adjudication process, and influence supplier and product selection.

Supplier relationships a measure of the overall success of BT's relationship with suppliers, based on our annual supplier survey

Non financial performance

Target 2012	2011	2010	2009
To achieve a rating of 80% or more based on a response of 'excellent' or 'good' to the question: How would you describe the quality of your company's relationship with BT?	86%	86%	85%

Financial performance

Total spend with external supply base	£11.3bn	£12.0bn	£13.0bn
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Ethical trading a measure of the application of BT's supply chain human rights standard

Non financial performance

Target 2012	2011	2010	2009
To achieve 100% follow up within three months for all suppliers identified as high or medium risk, through our ethical standard questionnaires	70 risk assessments with 100% follow up	180 risk assessments with 100% follow up	78 risk assessments with 100% follow up

Financial performance

Value of spend where our suppliers agree that BT ensures its purchase are made, delivered, used and disposed of in a socially and environmentally	86% of supplier	86% of supplier	83% of supplier
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responsible manner (extrapolated from supplier survey responses) spend spend spend

Payment of suppliers

In normal circumstances, BT's payment terms for contracted suppliers will be to pay each due, valid and undisputed invoice between 60 and 73 days from date of receipt from the supplier. There are variations to this policy. For example interconnect payments to other telecommunications operators, low value spend, various customer-specified requirements and rates are paid in shorter timescales. In 2011 the average number of days between the invoice date and the date of the payment run for the invoice was 64.

In the UK, BT provides access to a supplier financing scheme which offers contracted suppliers the opportunity to obtain payments in advance of the agreed terms of between 60 and 73 days from receipt of a valid and undisputed invoice. In addition, BT subscribes to the Better Payment Practice Code, details of which can be found at www.payontime.co.uk

Property portfolio

At 31 March 2011 we occupied around 6,500 properties in the UK, and around 1,850 properties in the rest of the world. The majority of the UK properties are owned by and leased from Telereal Trillium, which is part of the William Pears Group.

Approximately 89% of the UK portfolio consists of operational telephone exchanges which contain exchange equipment and are needed as part of our continuing activities. Other general purpose properties consist chiefly of offices, depots and computer centres. Approximately 87% of the properties in the rest of the world are operational sites.

In recent years, our strategic focus on cost transformation has led to significant reductions in our total labour resource. This has resulted in vacant space and under-utilisation of buildings within our UK property estate. Accordingly, in 2010 we initiated a property rationalisation programme to consolidate office space within the estate which has continued in 2011. See page 57 of the **Financial review** for further details.

Our group property team has instigated a number of initiatives to reduce waste to landfill, including changing contracts on its general waste to a recycling-led company and implementing new recycling schemes at many sites.

Waste to landfill and recycling a measure of BT's use of resources

Non financial performance

Target 2012	2011	UK only 2010	2009
BT Group will reduce the tonnage of waste sent to landfill by 20% from 2011 levels	69% reduction in waste to landfill from 2010	15% reduction in waste to landfill from 2009	17% reduction in waste to landfill from 2008

Financial performance

Net benefit to the business of the waste programme	£2.03m	£2.86m ^a	£3.79m ^a
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^a 2010 and 2009 figures are restated following a review

of expenditure
categorisation.

22

BUSINESS REVIEW

OUR LINES OF BUSINESS

BT Global Services

During 2011 we consolidated our position as a global leader in networked IT services. Order intake in the year grew by 10% as we signed contracts with major corporate and public sector customers. We have implemented a new global operating model and industry sector strategy, and have achieved our operating cash flow target a year ahead of plan.

£8,047m

Revenue

£593m

EBITDA

£119m

Operating cash flow

£7.3bn

Order intake

Business overview

BT Global Services is a global leader in the provision of managed networked IT services for large corporate and public sector customers. We provide services to around 7,000 large corporate and public sector customers with operations across the world in a wide range of sectors such as banking and financial services, consumer packaged goods, logistics, pharmaceuticals and manufacturing. We serve customers in the public sector in the UK, including central Government and local councils, as well as public sector organisations in countries outside the UK.

We operate domestic businesses in key markets in Europe such as Italy, Germany, and Spain, where we serve both multinational corporations and SME customers, and have local network infrastructure including high-speed fibre networks in key cities. We have operations across the Americas, and a strong business in Latin America based on an extensive satellite network. In 2010 we announced, and started to deliver on, a strategic investment plan to strengthen our business in the Asia Pacific region.

Our customers benefit from BT's global scale and operating model. Products are sold globally, and customers are served locally by our teams in their own countries and sectors who understand their specific business challenges and create locally relevant solutions. We call this operating globally and delivering locally.

We make this possible through our assets and skills. These include our global IP network, data centres, solution design and integration professionals and IT security experts. By combining network, IT and professional services we create managed solutions that help our customers to operate more efficiently.

Products and services

Networked IT services

We connect our customers to their customers through our Virtual Private Network (VPN), connectivity and value added services. We provide a range of products and services to do this such as BT MPLS, BT Etherflow and BT Application Assured Infrastructure (services to optimise application performance over networks).

Unified communications

We provide a range of communication services to enable organisations to collaborate and communicate better. This spans from the provision of PSTN and ISDN services, to our global managed services for IP telephony, and collaboration tools, either hosted on the customer site or as a cloud-based service.

Customer relationship management (CRM)

Through the combination of our professional services, cloud platforms and global inbound voice services, we offer a suite of CRM tools that give our customers the flexibility and value they require when dealing with their end customers.

Security

We provide a range of security and risk management products from professional services to assess risk and vulnerability, through to a suite of proactive managed security services.

Data centre services

With our global estate of data centres across the world, we provide a range of hosting and managed services. With the launch of our virtual data centre offering, BT Virtual Data Centre (VDC), we have a new generation of cloud-based services, giving our customers the flexibility and agility that comes from a cloud computing environment.

BUSINESS REVIEW OUR LINES OF BUSINESS

Mobility

We provide a range of value-added services to help customers exploit the benefits of mobile computing, from flexible working solutions through to services to enable customers to improve the efficiency of both their supply chains and workforces.

Operating review

Last year our focus was on improving the business through better financial and operational execution and the implementation of a strengthened controls environment. In 2011 we have reshaped and refocused our business to serve our customers better and established a significantly more competitive cost base.

We have continued to improve the efficiency of our operations, and reduce costs, helping to deliver a 7% reduction in net operating costs. We achieved this through:

improving service levels to take out cost of failure

working with our external suppliers to improve contract terms

reviewing our network and changing our network topography

rationalising our network assets and our operations

improving the service we get from suppliers around the world.

We have made changes to our global delivery model to improve contract execution. We improved our bid management processes and created three global bid management centres to standardise processes and share best practice. We have continued improving the start-up of major contracts, including standardised and accelerated start-up processes to improve contracts in the early stage of delivery.

During 2011, as part of our commitment to global customers in key industry sectors, we created four global strategic sector teams to sit alongside our four regions: Banking & Financial Markets; Commerce comprising manufacturing, logistics and pharmaceuticals; Consumer Packaged Goods; and Government & Health. Customers in these sectors will benefit from a range of industry focused products, solution design and infrastructure, as well as sector specific customer management and service teams.

GLOBAL BANKING & FINANCIAL MARKETS	GLOBAL COMMERCE (MANUFACTURING, LOGISTICS & PHARMACEUTICALS)	GLOBAL CONSUMER PACKAGED GOODS	GLOBAL GOVERNMENT & HEALTH
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UK

EMEA & LATIN AMERICA

UNITED STATES & CANADA

ASIA PACIFIC

During the year we signed contracts with a total order value of £7.3bn, up 10% over £6.6bn last year. The market environment continues to be challenging with fewer very large deals, longer lead times and pricing pressure all having an impact.

Notable contracts signed in the year include:

Customer	Contract
Unilever	A four-year extension to our existing contract to supply managed services in over 100 countries.
UBS	A new five-year contract for the provision of global voice and data network services, including a videoconferencing network and audio conferencing services.
Network Rail	A two-year extension of our networked IT services contract.
Defence Fixed Telecommunications Service (DFTS)	A three-year extension to our DFTS agreement with the UK Ministry of Defence.
Southwest One (working in partnership with Somerset County Council, Taunton Deane Borough Council, Avon and Somerset Police and IBM)	Provision of a high-speed network to 269 schools and educational establishments in Somerset, UK.
Ministerio de Defensa de España, Spain	Provision of internet access, security platform, and on-site professional services to the Spanish government.
DigitPA (Agency for the Digital Public Administration), Italy	A seven-year contract to connect 340 offices in 125 countries, providing communication services and managing a global network.

During the year we continued to execute on our larger customer contracts, for example working with other London 2012 Olympic and Paralympic Games technology partners, under the direction of the London 2012 Organising Committee, BT is building the communications infrastructure that will support the communications needs of the event. The project is on track.

We have made good progress on our large NHS contracts. Our work delivering clinical information systems at 80 NHS organisations across London and the South of England is now enabling around 170,000 healthcare professionals to provide better, safer patient care. N3, the secure national broadband network built and managed by BT for the NHS, now serves over a million NHS users. The Spine, the secure database and messaging service delivered by BT, continues to support the increased use of key transformational services, such as Choose and Book, the electronic appointment booking system, which saw the number of appointments booked electronically recently exceed 25m. During the year the UK Government announced a review of all public sector spending and BT entered into discussions with the Government on new arrangements designed to deliver efficiencies. In October 2010 BT announced the signature of a Memorandum of Understanding with the UK Government under which all of BT's central Government contracts remained in place.

During 2011 we launched new products and service enhancements, such as virtual data centre offerings, and a series of enhancements to our OneVoice collaboration and communications tools. New industry specific products and services were also launched, such as the collaboration suite for financial markets which includes a next generation range of trader voice and collaboration services.

24

BUSINESS REVIEW OUR LINES OF BUSINESS

We have also launched a range of products and services which help our customers reduce their environmental footprint including:

our sustainability practice and carbon impact assessment offer

a professional services smart grid offering in the US.

In May 2010 we announced a strategic investment plan to strengthen our business in the Asia Pacific region. We are recruiting up to 300 additional people in the key customer markets of Australia, China, Hong Kong, India, Japan and Singapore, in order to build up our sales and professional services teams, bid and project management, and service operations teams. This will allow BT to provide enhanced service delivery capabilities as customers invest throughout the region. Our continued commitment to the region and our customers was recognised through us winning the Telecom Asia Best Managed Services Provider award for the second consecutive year.

During the year we made steady improvements in managing customer service we had fewer abandoned calls, order accuracy improved and we reduced customer faults by 11%.

We were pleased to see our achievements recognised by external industry commentators, for example at the World Communication Awards where we won Best Global Operator and in our placements in key reports such as the March 2011 Gartner Magic Quadrant for Pan-European Network Services^a, and IDC MarketScape: Asia/Pacific Next-Generation Telecom Services 2010.

Financial performance

	2011	2010	2009
	£m	£m	£m
Revenue	8,047	8,513	8,628
Net operating costs	7,454	8,056	8,367
EBITDA	593	457	261
Depreciation and amortisation	734	815	776
Operating loss	(141)	(358)	(515)
Capital expenditure	498	599	886
Operating cash flow	119	(482)	(912)

In 2011 revenue decreased by 5% (2010: 1% decrease). Excluding the negative impact of foreign exchange movements and the reduction in low-margin transit revenue, underlying revenue excluding transit decreased by 4%, reflecting reduced UK calls and lines revenue. In addition, last year included revenue of around £100m from the early delivery of contract milestones.

	2011	2010	2009
	£m	£m	£m
Products and services			
ICT and managed networks	5,310	5,281	5,273
Calls and lines	822	956	1,055
Transit	623	782	869
Broadband and convergence	318	334	321

Other global carrier	206	229	237
Other products and services	768	931	873
Total	8,047	8,513	8,628

Revenue from networked IT services remained broadly flat (2010: broadly flat). Excluding the impact of around £100m in the prior year from the early delivery of contract milestones, revenue increased by 2%.

Calls and lines revenue decreased by 14% (2010: 9% decrease) reflecting the impact of the continuing trend of customers migrating to alternative IP based services.

Transit revenue decreased by 20% (2010: 10% decrease) largely due to the impact of mobile termination rate reductions in Continental Europe and the continuing trend of lower wholesale call volumes. Other global carrier revenue decreased by 10% (2010: 3% decrease) due to lower volumes.

Broadband and convergence revenue decreased by 5% (2010: 4% increase). Other revenue, principally comprising global product revenues, decreased by 18% (2010: 7% increase) partially due to foreign exchange movements and lower global demand.

Net operating costs decreased by 7% (2010: 4% decrease) or 6% excluding transit. This improvement reflects further progress with our cost efficiency initiatives during 2011 as set out on page 24.

Our progress in addressing the cost base is demonstrated by the 30% increase in EBITDA (2010: 75% increase) to £593m.

Depreciation and amortisation decreased by 10% (2010: 5% increase) reflecting the reduction in capital expenditure over the last two years.

The operating loss was £141m, a significant improvement compared with losses of £358m and £515m in 2010 and 2009, respectively.

Capital expenditure reduced by 17% (2010: 32% decrease) due to the timing of capital expenditure across certain of our large customer contracts, the application of more stringent investment return criteria and improved procurement and programme delivery.

Operating cash was an inflow of £119m, a significant improvement from an outflow of £482m in 2010 and £912m in 2009. The improvement was achieved through higher EBITDA, improved working capital and lower capital expenditure. We expect to generate around £200m of operating cash flow in 2012.

^aThe Magic Quadrant is copyrighted 2011 by Gartner, Inc. and is reused with permission. The Magic Quadrant is a graphical representation of a marketplace at and for a specific time period. It depicts Gartner's analysis of how certain vendors measure against criteria for that marketplace, as defined by Gartner. Gartner does not endorse any vendor, product or service depicted in the Magic Quadrant, and does not advise technology users to select only those vendors placed in the Leaders quadrant. The Magic Quadrant is intended solely as a research tool, and is not meant to be a specific guide to action. Gartner disclaims all warranties, express or implied, with respect to this research, including any warranties of merchantability or fitness for a particular purpose.

BUSINESS REVIEW OUR LINES OF BUSINESS

BT Retail

Broadband performance has been a highlight of the year, with our highest quarterly share of DSL and LLU net additions in eight years. Take-up of our BT Infinity fibre-based broadband product continues to accelerate.

£7,748m

Revenue

£1,784m

EBITDA

64%

Retail share of DSL and LLU broadband net additions in the fourth quarter

5.7m

Total broadband customers

1m

SME customers

Business overview

BT Retail serves UK and Republic of Ireland consumers and SMEs through four customer-facing divisions: BT Consumer, BT Business, BT Enterprises and BT Ireland. BT Enterprises also serves global customers.

BT Consumer

BT is the leading provider of fixed-line voice and broadband services in the UK market. We offer our customers a range of innovative and value-for-money calls, lines, broadband and TV packages.

Products and services

Calls and lines

We provide call services to over 10m of our fixed-line customers, offering value-added services like call minder, and value-for-money unlimited call plans which include free access to 0800 and 0845 numbers.

Broadband

We serve the consumer broadband market with the BT and Plusnet brands. BT Total Broadband provides value-added services such as online storage, security and free access to the largest network of wi-fi hotspots in the UK, while Plusnet focuses on simple broadband packages for price-conscious customers. BT Infinity is our super-fast broadband product, delivering download speeds of up to 40Mbps using FTTC technology.

TV

BT Vision – our television service – has over 8,000 items of video on-demand content available and offers BBC iPlayer plus TV replay services from ITV and Channel 4. BT Vision also now offers Sky Sports channels on flexible contract terms and HD and 3D movies available for download.

YouView, the TV joint venture between the BBC, ITV, Channel 4, BT and others, will transform the UK TV market, combining free digital channels with free on-demand content from public service broadcasters delivered over broadband. The full commercial launch of YouView is planned for early in the 2012 calendar year.

BT Business

We supply and support business calls and lines, broadband, internet, mobiles and mobile applications, domains and web hosting, data and voice networks and IT services for SMEs. We sell to SME customers through our call centres, online, or via our desk and field-based account teams. We also serve the market via a network of 43 BT Local Businesses – regional franchises with their own sales staff and account management teams. Specialist business units within BT Business include:

BT iNet: a Cisco centre of excellence specialising in infrastructure, security and unified communications

BT Engage IT: a leading provider of business-to-business IT solutions and services

BT Business Direct: an online store providing IT, computing and networking equipment plus associated installation and support services for SMEs.

BUSINESS REVIEW OUR LINES OF BUSINESS

BT Enterprises

BT Enterprises consists of a portfolio of five separate businesses:

BT Conferencing	Global provider of audio, video and internet conferencing and collaboration services
BT Directories	Directory Enquiries (118 500), operator and emergency services. The Phone Book and online web reviews of businesses
BT Expedite	Software and IT services for medium-sized retailers
BT Redcare & Payphones	Residential and business alarm monitoring and tracking facilities. Managed, prison, card and private payphones, as well as meeting our regulatory obligations to provide a public payphone service
BT Openzone	Provision of premium wi-fi hotspots offering broadband on the move to retail customers and to wholesale customers such as mobile network operators.

Each of these businesses operates as a standalone business, with the support of BT's brand and customer relationships. BT Enterprises also serves larger organisations in the UK and worldwide largely through BT Conferencing.

BT Ireland

BT Ireland operates in Northern Ireland and in the Republic of Ireland. In Northern Ireland we are the leading provider of communication services to consumers, SMEs and the government sector. We are also responsible for providing regulated wholesale access via Openreach. In the Republic of Ireland, we are one of the largest providers of wholesale network services to CPs.

Operating review

Despite the challenge of highly competitive markets we have grown in broadband, TV and the IT services market while improving efficiency and reducing customer complaints. We remain focused on reducing costs by simplifying, standardising and automating processes.

We have a range of programmes in progress designed to improve customer service and reduce costs which declined 6% in the year. Over the past two years we have reduced customer complaints by 42% while cutting service costs by enhancing self-service capabilities and reducing the number of repeat contacts from customers. A particular area of success has been the expansion of our Digital Care channels where customers can contact us or find self-help support via channels such as Twitter, YouTube and the bt.com community forums.

BT Consumer

Following the relaxation of Ofcom restrictions in 2009 we have been able to compete more effectively with other companies offering bundled services, combining calls, broadband and TV services. Bundle sales account for around 90% of new broadband installations and 1.4m of our customers now take bundles of services. This has contributed to increased average annual revenue per consumer user (ARPU) up to £326 as consumers take more products from us. In the broadband market, BT's retail share of the DSL and LLU base has remained at around 36% despite an increasingly competitive market. Our retail share of net DSL and LLU additions in the fourth quarter was 64% the highest level achieved in eight years driven by competitively priced bundles and seasonal promotions supported by marketing activity.

We have seen significant demand for BT Infinity, our super-fast fibre-based broadband proposition currently offering download speeds of up to 40Mbps and upload speeds of up to 10Mbps. Following the launch in January 2010, our BT Infinity customer base is now 144,000 and, in March 2011, 46% of customers who ordered broadband took BT Infinity in areas where it is available.

We are currently trialling our FTTP solution which will provide download speeds to 100Mbps, offering further benefits to consumers.

The Plusnet brand continued to grow, with 31% of the Plusnet customer base now taking voice and broadband services together. Plusnet's success has been driven by a combination of competitively priced packages, self-care tools for customers, referral discounts and a national marketing campaign. Plusnet also collected a number of industry awards during the year from Simplify Digital, Broadband Genie, PC Advisor and uSwitch. It was also ranked highest in the UK for customer service by JD Power. In April 2011 Plusnet launched its own, competitively priced super-fast fibre-based broadband proposition, offering customers download speeds of up to 40Mbps via FTTC.

BUSINESS REVIEW OUR LINES OF BUSINESS

Our television service, BT Vision, had 575,000 customers at 31 March 2011 (2010: 467,000). Following the Ofcom pay TV market investigation in March 2010, we launched Sky Sports 1 and Sky Sports 2 on BT Vision in time for the 2010-11 Premier League football season. We also launched the BBC iPlayer service on BT Vision and expanded our range of HD content, adding 3D movies for the first time and enhancing our HD download service to provide a better customer experience.

Our BT broadband customers benefit from free access to the largest wi-fi hotspot network in the UK. Comprising BT Openzone, BT Fon and Business Hubs, our customers can now get online at more than 2.8m locations. We have also launched the BT Fon application for smartphones and tablet computers which automatically connects to the BT wi-fi network and has been downloaded over half a million times.

In January 2011 we launched our new Home Hub 3, including Smart Wireless which looks for the best wireless channel to ensure the strongest possible connection at all times. It uses 39% less power and its smaller design typically uses 25% less plastic than previous models.

BT Business

BT Business has seen continued growth in IT services and mobility revenue up 17% and 14%, respectively, and an improvement in line losses with net line losses in the second half of 2011 being 35% lower than in the same period in 2010. During the year we launched a range of new business broadband propositions, offering a combination of competitive prices and tiered service levels as well as fibre-based broadband offers.

We have also built our capabilities in the IT services market through BT Engage IT and BT iNet. This year BT Engage IT announced it would offer pay as you go information security from Symantec to offer value and flexibility to customers. BT iNet also now installs, integrates and maintains a virtual data centre hosting solution for SME customers. Our BT Business Direct online store provides IT, computing and networking equipment plus associated installation and support services for SMEs.

BT Enterprises

Note: BT Openzone revenues are currently recognised within other units.

BT Conferencing launched Mobile Controller and Desktop Controller products for audioconferencing services which allow customers to control their audioconferences from their mobile or desktop more easily. We also launched interoperability for our telepresence videoconferencing services.

In 2011 BT Directories released the compact Phone Book, reducing its size by 15% to fit into letter boxes, saving 2,000 tonnes of paper each year. BT Directories also launched a free Android smartphone application to make The Phone Book available to mobile users.

BT Expedite delivered a new mobile-optimised web site for fashion clothing brand, Lyle & Scott and extended the multichannel capability for Pets at Home with the addition of Click and Collect.

The volume of traffic carried by the BT Openzone network more than doubled compared with the previous year to around 3bn minutes. In August 2010 BT signed a contract with Starbucks Coffee Company to provide wi-fi across some 140 Starbucks coffee shops in Germany, extending BT's relationship with Starbucks in the UK and Ireland.

BT Ireland

While BT Ireland's revenue was impacted by the challenging economic conditions, profits increased as a result of ongoing cost transformation programmes and the delivery of large retail and wholesale contracts.

During the year we rolled out super-fast fibre-based broadband services in Northern Ireland. This investment, in partnership with Northern Ireland's Department of Enterprise, Trade and Investment (DETI), will result in 89% of lines being connected to a fibre broadband cabinet by March 2012.

In the Republic of Ireland, BT secured a number of significant contracts in the corporate, government and wholesale sectors including Danske Bank, Element Six and Pinebridge Investments.

Financial performance

2011	2010 ^a	2009 ^a
£m	£m	£m

Revenue	7,748	8,124	8,491
Net operating costs	5,964	6,347	6,906
EBITDA	1,784	1,777	1,585
Depreciation and amortisation	443	459	426
Operating profit	1,341	1,318	1,159
Capital expenditure	434	417	471
Operating cash flow	1,382	1,566	984

^a Restated. See
page 106.

In 2011 revenue decreased by 5% (2010: 4%). Excluding a one-off benefit of £40m in 2010 relating to prior periods, the decrease was 4%. Revenue in the second half of 2011 was down 3%, an improvement on the 5% decline in the first half after excluding the one-off benefit in 2010.

BUSINESS REVIEW OUR LINES OF BUSINESS

BT Consumer revenue decreased by 6% (2010: 3%) as the reduction in calls and lines revenue more than offset growth in broadband revenue.

BT Business revenue decreased by 1% (2010: 8% decrease), as declines in calls and lines revenue were largely offset by growth in IT services and mobility revenue.

BT Enterprises revenue decreased by 2% (2010: 2% increase) principally due to lower revenue in BT Redcare & Payphones.

BT Ireland revenue decreased by 6% (2010: flat). Excluding the negative impact of foreign exchange movements and the reduction in low-margin transit revenue, revenue decreased by 3%, in a difficult economic climate.

	2011	2010 ^a	2009 ^a
	£m	£m	£m
Products and services			
Calls and lines	4,491	4,953	5,346
Broadband and convergence	1,311	1,258	1,253
ICT and managed networks	551	578	591
Other products and services	949	962	958
External revenue	7,302	7,751	8,148
Internal revenue	446	373	343
Total	7,748	8,124	8,491

^a Restated. See page 108.

Calls and lines revenue decreased by 9% in 2011 (2010: 7% decrease) in what continues to be a competitive market environment.

Broadband and convergence revenue increased by 4% (2010: broadly flat) reflecting the success of our broadband strategy, together with increased revenue from services such as mobility.

ICT and managed networks revenue decreased by 5% in 2011 (2010: 2% decrease).

Net operating costs decreased by 6% (2010: 8% decrease). The prior year included a favourable one-off internal rebate of £15m relating to prior periods. The decrease reflects the reduction in revenue but also our cost efficiency initiatives. Labour productivity efficiencies resulted in a 7% reduction in total labour costs. These savings were offset by the planned investment in subscriber acquisition costs, marketing and product development to drive future revenue growth.

The above factors contributed to a small increase in EBITDA to £1,784m in 2011 (2010: 12% increase). However, excluding the one-off benefits of £55m in 2010, the increase in 2011 was 4%.

Depreciation and amortisation decreased by 3% (2010: 8% increase) due to the lower level of capital expenditure in recent years.

Operating profit increased by 2% in 2011 (2010: 14% increase). Excluding the one-off benefits of £55m in 2010, the growth in 2011 was 6%.

Capital expenditure increased by 4% in 2011 (2010: 11% decrease) as a result of the continued investment in higher speed broadband services and the investment in the fibre-based broadband roll-out in Northern Ireland.

Operating cash flow decreased by 12% in 2011 (2010: 59% increase). This reflects the impact of some strong working capital receipts in 2010.

BUSINESS REVIEW OUR LINES OF BUSINESS

BT Wholesale

During 2011 we continued our transformation from a traditional product-based wholesale business to one focused on an IP future, entering adjacent markets such as digital content distribution and delivering long-term managed services to our wholesale customers.

£4,210m

Revenue

£1,316m

EBITDA

24%

of external revenue from managed network services contracts

40%

of external revenue under long-term contracts

Business overview

BT Wholesale provides a broad range of voice, broadband and data communications services, including managed network services (MNS) for fixed and mobile network operators (MNOs), ISPs and telecoms resellers in the UK. Through our Media and Broadcast and agilemedia business units we also support the network needs of global broadcasting organisations, from connectivity and digital media management to production, post-production and interactive audience participation. Through close collaboration with Global Telecoms Markets – the wholesale arm of BT Global Services – the business also supports the needs of communications provider customers worldwide.

Over the last three years we have built a successful MNS business for fixed and mobile CPs with differing requirements, from fully managed network outsourcing for operators with significant network assets to white label managed services designed to help brand extenders with limited or no infrastructure.

We manage and support the network and services requirements of a number of national operators including KCOM Group, Virgin Media, Orange UK, Vodafone, O2 and MBNL. By making our networks and services available to other CPs, we provide them with an alternative to building their own network infrastructure.

We have long-term MNS contracts in place with all of the UK's mobile network operators to help them manage the growth in mobile data and video content generated by 3G services with high speed data connections that link mobile base stations to their and BT's core networks.

BUSINESS REVIEW OUR LINES OF BUSINESS

Products and services

Wholesale broadband

We are the UK's largest wholesale provider of broadband, nationally measured by reach and revenue. This includes sales to CP customers with their own broadband infrastructure but which choose our services outside their own network footprints, as well as other parts of the BT Group.

We offer a range of broadband services, delivered over copper and fibre with speeds of up to 8Mbps (ADSL), up to 20Mbps (ADSL2+) and up to 40Mbps over fibre. At 31 March 2011 our up to 20Mbps service, was available from exchanges serving over 65% of UK premises (2010: 55%). At the end of March 2011 more than 35 CPs were either selling or trialling our fibre-based broadband service.

Content distribution network

During the year we developed a content distribution network to help our CP customers manage the rapidly rising volume of video content which is being downloaded over fixed and mobile broadband networks. Our network will make this traffic more cost-efficient for CPs to manage and, through the provision of quality of service, will enable assured quality and a range of new business models for digital content.

Wholesale Ethernet

We offer IP-based Ethernet services giving customers high-speed data connectivity at a range of speeds up to 1Gbps. At 31 March 2011 Wholesale Ethernet over fibre was available from over 1,000 nodes throughout the UK (2010: 800 nodes).

Private and partial private circuits

BT Wholesale is a major provider of traditional data circuits in the UK which help our customers to extend the reach of their services and act as infill solutions for their own networks.

Capacity and call-based products

We continue to sell a wide range of capacity and call-based products and services, both regulated and non-regulated, using both traditional and IP technologies. As we refresh our core portfolio with next generation replacements, we are migrating these services to our IP network platform. One of these new products is IP Exchange, BT Wholesale's global IP interoperability platform that allows CPs to manage traditional and IP voice calls on a single gateway, regardless of whether the calls are from mobile or fixed handsets.

White label managed services

Our white label managed services business enables customers with limited or no infrastructure to offer telecoms services such as telephony and broadband without the need to invest capital. We provide a complete service, from accepting and processing new orders through to customer service and end user billing.

Operating review

We are committed to becoming our customers' partner of choice by continuously improving our service delivery and customer satisfaction, reducing cost, evolving our traditional product portfolio and launching new IP-based services. We reduced operating costs by 11% in the year, largely by eliminating the cost of failure through improvements in the delivery of products and getting services' right first time'. We have reduced the cost of service delivery by 46% over the last three years, reduced discretionary spend and consolidated our property portfolio to reduce costs.

In May 2010 we announced the availability of our global IP Exchange platform, which is now in use by over 120 fixed-line and mobile operators worldwide. The number of minutes carried over the platform doubled over the last year.

We also launched a 1Gbps Ethernet service nationally in the UK and the sale of our fixed-line Ethernet service increased more than three-fold over the previous year.

In March 2011 we launched our first digital content distribution propositions to the UK market.

The majority of BT Wholesale's largest UK customers by revenue have signed long-term contracts, typically for between three and five years. As a result, the proportion of our external revenue underpinned by long-term contracts remained at 40% in 2011.

Revenue from MNS contracts continued to grow, and accounted for 24% of external revenue in 2011, up from 21% in the previous year. These contracts include a high proportion of products and services with low levels of bespoke development. This allows us to defend existing product and service revenues, as well as creating new opportunities for growth.

During 2011 we signed managed network services contracts with a total order value of £1.2bn (2010: £1.8bn). These included:

Date	Customer	Details
May 2010	Scottish and Southern Energy (SSE)	Re-sign of a long-term agreement for fully managed voice and wholesale line rental services that SSE resells under its own brand to more than 250,000 consumers in the UK.
Feb 2011	KCOM Group	Five-year extension of our national managed network outsourcing agreement with KCOM Group with the addition of a hosted IP Voice service that KCOM is reselling.

A number of our existing managed network services agreements have led to follow-on contracts, such as a power management contract with Virgin Media.

Our commercial satellite services are also helping non-governmental organisations provide critical aid services in hard to reach locations and support the delivery of education services in developing countries. Our satellite services are helping to improve the accuracy of European GPS services and are being used by UK energy suppliers to link remote wind farms in the UK to centralised monitoring systems.

During the year, BT Wholesale was named **Best Wholesale Carrier** for the first time at the World Communication Awards 2010.

Financial performance

	2011 £m	2010 ^a £m	2009 ^a £m
Revenue	4,210	4,592	4,800
Internal revenue	980	1,226	1,228
External revenue	3,230	3,366	3,572
Net operating costs	2,894	3,239	3,444
EBITDA	1,316	1,353	1,356
Depreciation and amortisation	619	680	686
Operating profit	697	673	670
Capital expenditure	329	325	435
Operating cash flow	911	917	903

^a Restated. See page 106.

BUSINESS REVIEW OUR LINES OF BUSINESS

In 2011 revenue declined by 8% (2010: 4% decline). After reflecting changes in the internal trading model in 2011, which impacted internal revenue by £204m in 2010, revenue declined by 4%. Excluding low-margin transit revenue, underlying revenue declined by 3%.

	2011	2010 ^a	2009 ^a
	£m	£m	£m
Products and services			
Transit	895	976	1,134
Conveyance and interconnect	609	578	728
ICT and managed networks	771	715	518
Broadband and convergence	335	488	543
Calls and lines	282	316	398
Other products and services	338	293	251
External revenue	3,230	3,366	3,572
Internal revenue	980	1,226	1,228
Total	4,210	4,592	4,800

^a Restated. See page 108.

Transit revenue decreased by 8% (2010: 14% decrease) as a result of transit volume reductions and the price impact of regulatory mobile termination rate reductions.

Conveyance and interconnect revenue increased by 5% (2010: 21% decrease) driven by higher volumes.

Broadband and convergence revenue decreased by 31% (2010: 10% decrease) due to securing volumes under long-term MNS contracts and, to a lesser extent, the continuing trend of CPs switching to LLU provided by Openreach.

The declines have been partly offset by an increase of 8% in MNS revenue (2010: 38% increase). The rate of growth has slowed compared with 2010 as the focus on contracts has switched to delivery and achieving key milestones.

Calls and lines revenue decreased by 11% (2010: 21% decrease) reflecting lower circuit volumes as customers seek alternative products and services such as Ethernet.

Other products and services revenue increased by 15% (2010: 17% increase) partly driven by growth in IP-based Ethernet services.

Net operating costs decreased by 11% (2010: 6% decrease) or 5% after reflecting the impact of changes in the internal trading model. Excluding transit, the decrease was 3%. The decrease was partly due to the decline in revenue, but also due to the impact of our cost efficiency programmes principally through reductions in our total labour resource.

The above factors contributed to a 3% decrease in EBITDA (2010: broadly flat).

Depreciation and amortisation decreased by 9% to £619m (2010: 1% decrease).

Operating profit increased by 4% (2010: broadly flat) due to the decline in EBITDA being offset by lower depreciation and amortisation.

Capital expenditure increased by 1% (2010: 25% decrease), reflecting the increased investment in our Ethernet and Wholesale Broadband Connect footprints.

Operating cash flow decreased by 1% in 2011 (2010: 2% increase). After adjusting 2010 for the intra group VAT settlement with Openreach, operating cash flow decreased by 7%, primarily due to the timing of working capital payments and the increase in capital expenditure.

BUSINESS REVIEW OUR LINES OF BUSINESS

Openreach

During the year we continued to roll out our super-fast broadband at scale and are on track to pass 5m homes inspring 2011. For the first time since we were formed, we have seen growth in our copper line base.

£4,930m

Revenue

£2,132m

EBITDA

11,000

Growth in copper line base in 2011

62%

Increase in Ethernet connections

Business overview

Openreach is responsible for the last mile of the UK access network the copper wires and fibre connecting homes and businesses to their local telephone exchange via fixed-line local and backhaul connections. Openreach connects 5,600 exchange areas through approximately 120m kilometres of copper wire. All Openreach customers currently approximately 490 CPs, including other BT lines of business are offered fair, equal and open access to its networks. We have nearly 19,000 field engineers who work on behalf of all CPs, enabling them to provide their customers with a range of services from analogue telephone lines to complex networked IT services.

Products and services

Wholesale line rental

Wholesale line rental (WLR) enables CPs to offer telephony services with their own brand and pricing structure over BT's network.

Local loop unbundling

LLU enables CPs to use the lines connecting BT exchanges to end users premises, and to install their own equipment in those exchanges.

Ethernet

Openreach's Ethernet products offer CPs a wide choice of high bandwidth circuits to build or extend their customers data networks.

Fibre-based broadband

Openreach plans to make fibre-based services available to 10m UK premises by 2012 and to two thirds of premises by the end of 2015, offering speeds of up to 100Mbps. Super-fast fibre access is provided by our Generic Ethernet Access product which comes in two types: FTTC offering download speeds of up to 40Mbps and upload speeds of up to 15Mbps; and FTTP offering download speeds of up to 100Mbps and upload speeds of up to 30Mbps. There are a number of CPs currently offering or trialling FTTC and FTTP.

At 31 March 2011 Openreach had identified 12 trial sites for its FTTP product and already passed over 12,000 UK premises.

Operating review

2011 was an extremely busy year for Openreach with high levels of demand across our products. At 31 March 2011 Openreach was providing 16.9m WLR lines to other BT lines of business, and 6.2m to other CPs.

By the end of the year, 89% of UK premises were served by an unbundled exchange and there were 15.7m unbundled lines in the UK, up 6.5% on the previous year. Of these, 8.1m were for other BT lines of business to support broadband services and 7.6m were for other CPs. Thirty CPs are providing unbundled services, and Openreach is fulfilling more than 100,000 LLU orders a week.

This increase in LLU uptake was stimulated by further demand in the broadband market and drove overall engineering provision visits up over 25% year-on-year. We completed over 65,000 Broadband Boost visits where engineers visit

homes to improve broadband services.

BUSINESS REVIEW OUR LINES OF BUSINESS

The 11,000 net increase in the copper line base was the first growth since the formation of Openreach in 2006. We also began to see an acceleration in the number of end-users on our fibre-based services.

Across other products we continued to grow our Ethernet base with connections up 62%.

Repair visits increased 21% year-on-year partly because of the extra activity in the network. The repair workstack reached its peak during January and this was due to increased provision volumes coupled with very poor winter weather conditions and a 134% increase in faults relating to cable theft and vandalism. These attacks accounted for 85,000 faults on the live network.

Our focus on engineer task times (average task times for repair/provision fell 19% and 10%, respectively) and short-term use of additional engineering resource helped to improve the workstack as we reached the end of the year. The repair workstack increase resulted in a slight fall in our mean time between faults, which stands at one fault every 14 years, but still compares favourably with our historical performance.

Openreach operates an engineering fleet of more than 21,000 vehicles and is committed to finding innovative ways to minimise its environmental impact. For example, over 18,500 of our vehicles are now equipped with satellite location technology that is designed to improve the efficiency of engineering visits, thereby reducing fuel usage. During the year we have reduced our total fleet by just under 500 vehicles and on a like-for-like basis, considering the increases in both provision and repair visits, we reduced our fuel usage per visit by 11%.

Financial performance

	2011	2010 ^a	2009 ^a
	£m	£m	£m
External revenue	1,459	1,241	1,042
Revenue from other BT lines of business	3,471	3,923	4,189
Revenue	4,930	5,164	5,231
Net operating costs	2,798	3,204	3,235
EBITDA	2,132	1,960	1,996
Depreciation and amortisation	877	856	778
Operating profit	1,255	1,104	1,218
Capital expenditure	1,087	907	951
Operating cash flow	1,078	1,167	1,079

^a Restated. See page 106.

In 2011 revenue decreased by 5% (2010: 1% decrease). After reflecting changes in the internal trading model in 2011, which impacted internal revenue by £204m in 2010, revenue was 1% lower. Higher LLU and Ethernet volumes and provisions activity were largely offset by price reductions and the continued migration from WLR to lower priced Metallic Path Facility (MPF).

External revenue was £1,459m in 2011, an increase of 18% (2010: 19% increase) and reflects the continuing migration of end customers to other CPs WLR and LLU products. External revenue represented 30% of our revenue in 2011 (2010: 24%).

Revenue from other BT lines of business decreased by 12% to £3,471m in 2011 (2010: 6% decrease). After reflecting changes in the internal trading model, revenue from other BT lines of business decreased by 7% reflecting the shift of WLR and LLU volumes from other BT lines of business to external CPs and the effect of lower Ethernet prices, partly offset by volume increases.

Net operating costs reduced by 13% (2010: 1% decrease). After reflecting the impact of changes in the internal trading model and excluding leaver costs, net operating costs reduced by 5% in 2011 achieved through process efficiencies in volume engineering activities.

EBITDA increased by 9% (2010: 2% decrease) as the cost efficiencies have offset the reduction in revenue.

Depreciation and amortisation increased by 2% (2010: 10% increase) reflecting investment in our next generation broadband, Ethernet and fibre services.

Operating profit increased by 14% in 2011 (2010: 9% decrease).

Capital expenditure increased by 20% (2010: 5% decrease) due to the investment in our super-fast fibre-based broadband network and the increase in CP's infrastructure build and provision activities.

Operating cash flow decreased by 8% (2010: 8% increase). After adjusting 2010 for the intra group VAT settlement with BT Wholesale, operating cash flow decreased by 2% in 2011 as the higher capital expenditure was largely offset by the increased EBITDA.

34

BUSINESS REVIEW OUR LINES OF BUSINESS**BT Innovate & Design**

BT Innovate & Design is responsible for the innovation, design, development and delivery of the processes, networks and platforms on behalf of the customer-facing lines of business. These are run by BT Operate.

BT Innovate & Design has an operating model focused on delivery, with strong cost and quality management, which includes the whole lifecycle of both the network and associated software. In addition, by having the innovation, design and development skills within one team we are able to bring innovation closer to the customer, bringing new ideas, products and services to market faster, cheaper and more effectively for our customers. This is supported through the use of global development centres in the UK, US, Europe and India which improve collaboration, agility and efficiency in network and software development by bringing together the development teams and customers.

We continue to reduce our cost base through a combination of cost controls and efficiency measures. In 2011 we reduced our unit costs by 12% (2010: 31%) through a quality delivery process, which focuses on re-use, consolidation and standardisation, by developing software which can be used to guide decisions about development, and supplier management.

We embed sustainability into our current innovation and design approach by including energy usage as a design criteria in our network and service architectures both for BT internal use and to enable our lines of business to offer low carbon products and services to customers. For example, in 2011 we developed an ADSL technology called Cool Broadband that configures ADSL lines to be always available rather than always fully on and has the potential to reduce energy consumption by around 30% per line without affecting the customer's experience. During 2011 we successfully conducted customer trials and we are working with suppliers towards a development plan.

To ensure our focus on being a sustainable and responsible business leader well into the future, we have a dedicated research team focused on developing opportunities for future gains in energy and carbon management and on using cutting edge technologies to improve accessibility and inclusion for the hearing, sight and physically impaired.

BT Operate

BT Operate manages BT's IT and network infrastructure platforms as a single converged operation, providing a seamless IT infrastructure. BT Operate also runs parts of other CPs' networks on behalf of the customer-facing lines of business, and is responsible for delivery of the products and services BT sells to its customers.

We monitor the reliability of BT's networks and systems, and during 2011 we had challenges but in the fourth quarter we saw an improvement in performance. A key driver to the improvement is due to uplifts on our core network platforms and systems infrastructure.

	Q4 2011	Q4 2010	
Reliability performance measure	28.2% improvement over fourth quarter of 2010	10.8% improvement over fourth quarter of 2009	Reliability is measured as the reduction in frequency and duration of network and system outages for certain product journeys.

We establish and manage security policy and processes throughout BT, enabling us to meet the requirements of our customers, both in the UK and globally.

BT Operate manages the group's energy strategy which aims to reduce consumption, establish security of supply and reduce carbon emissions. Networks and data centres managed by BT Operate account for a significant amount of BT's energy consumption in the UK.

This year, BT has reduced global energy consumption by 2.5% compared with 2010. This is the second consecutive year that BT has reduced overall energy consumption, despite additional energy required for business growth and expansion of networks. In the UK, energy consumption has reduced by 2.6% compared to 2010.

Our energy consumption reductions have been achieved by driving key initiatives including Smart Energy Control by delivering building energy management systems to many sites with further sites planned for 2012. They have also been achieved by replacing energy-inefficient equipment, and decommissioning and rationalising our estate.

BUSINESS REVIEW

OUR CORPORATE RESPONSIBILITY

Introduction

Building stronger communities

Reducing carbon emissions and our impact on the environment

Behaving responsibly

Our corporate responsibility risks

Further information

Taking corporate responsibility and sustainability seriously has been important to BT for many years. To better reflect this, we updated our business strategy this year, so that being a responsible and sustainable business leader became one of our strategic priorities. This will help us to further integrate sustainability into our daily decision-making.

Our approach to developing and delivering our corporate responsibility

Introduction

We have a long track record of acting responsibly and supporting the communities to whom we deliver services. Our support for Children in Need telethons dates back to 1980, and that for Comic Relief to 1988. Our environmental management system dates back to 1991. We have long-standing ethical supply chain management processes and policies on equal opportunities, fair pay and anti-bullying.

One way in which businesses strive to do better in terms of acting responsibly is to compete with others for awards. We enter these to help benchmark ourselves against the efforts of other like-minded organisations. In 2011 we were proud that we maintained gold sector status in the Dow Jones Sustainability Index and Platinum Plus level in the Business in the Community Corporate Responsibility Index, as well as attaining a place in the FTSE4Good Index. We were in joint first place in the Carbon Disclosure Project's Leadership Index, won the World Communication Award Green Award and won the Edie Award for Environmental Excellence in the Sustainable Transport category. We are focused on a number of strategic priorities and in 2011 we added a new strategic priority to be a responsible and sustainable business leader to leave no doubt about the importance we place on acting ethically and in the interests of the environment. This reflects an ongoing commitment to integrate the principles of sustainability into the way we do business.

We measure progress towards our corporate responsibility (CR) goals in accordance with the principles of the Connected Reporting Framework sponsored by HRH the Prince of Wales. Our sustainability report provides full details of our progress and can be found online at www.bt.com/betterfuture

We are focusing our activity on three areas to deliver our new strategic priority:

building stronger communities through the power of our technology and people

reducing carbon emissions and our impact on the environment through our operations and products

behaving responsibly towards our customers, people and suppliers.

The importance of CR is emphasised by the existence of a Board Committee dedicated to CR and chaired by the BT plc Group Chairman. We also receive advice from an external leadership panel of independent experts. See **Report of the directors Report of the Committee for Sustainable & Responsible Business** on page 68 for more information.

Building stronger communities

We are using our technology and the skills and creativity of our people to make a positive difference to the communities in which we work.

Digital inclusion

The economic benefit of getting everyone online in the UK is estimated at £22 billion (the Economic Case for Digital Inclusion PricewaterhouseCoopers LLP, October 2009). We help communities enjoy the benefits of technology through our commitment to improve digital inclusion. We aim to get at least 100,000 digitally excluded people online as part of our support for the UK's Race Online 2012. We have underpinned this with our large investment in the UK's digital infrastructure and programmes like our Race to Infinity – an online vote which resulted in winning communities being prioritised as part of our fibre roll-out programme.

36

BUSINESS REVIEW **OUR CORPORATE RESPONSIBILITY**

We support older and less able customers through our accessible services. In 2011 we launched BT's Including You website, which offers a range of accessible products and services for those who need extra help with communications. We are proud that the initiative was the first to receive a new accreditation mark from AbilityNet, a charity that enables people with disabilities to access technology and the internet.

Skills and training

We support customers who feel they do not have the skills to use our services through our Get IT Together programme launched in 2010.

In many countries around the world we also provide community investment support to address digital inclusion locally. In India, our support for the Katha Information Technology and E-Commerce School (KITES) equips students with the IT skills that will help them to build promising careers in the local job market. We have digital inclusion programmes in the US, Colombia, Spain and South Africa. Our contribution to digital inclusion around the world supports our brand and helps us to contribute to building stronger local communities.

Charitable involvement

We work closely with charities to help them enhance their capacity and their fundraising. We help community and charity groups build an online presence through resources such as our Community Web Kit.

BT Troubleshooter is a new free service that gives UK charities access to BT people to help them to tackle particular problems.

Our support for telethons continues to assist charities with their fundraising. In 2011 our technology and employee volunteers helped Children in Need and Comic Relief raise over £34m through BT supported telethons.

In April 2011 BT launched a new online fundraising service for UK charities called MyDonate (www.bt.com/mydonate), the first online fundraising service not to charge a subscription fee or take commission. We developed the MyDonate service with a number of charities including Cancer Research UK, Changing Faces, Kids Out, NSPCC and Women's Aid. We were encouraged that within days of launch, hundreds of charities had signed up to exploit this new platform for giving.

We also support our employees in their involvement in charities and community groups. We did this in 2011 through our employee volunteering programme, our employee charity match programme and through our BT Community Champions programme. In 2010 we asked our people to vote on which charities they wanted to be the company's fundraising charity partners. They chose Cancer Research UK to join ChildLine. We are pleased to work with these organisations.

Overall this year BT invested money, time and in-kind contributions worth £27.6m in supporting responsible and sustainable business activities.

Reducing carbon emissions and our impact on the environment

BT aims to reduce its impact on the environment through a range of initiatives. These include reducing energy and water use, generating our own renewable energy, bringing down waste and implementing responsible product stewardship.

Reducing our own emissions and energy usage

Our aim is to continue to reduce carbon emissions. We have set ourselves an ambitious carbon emissions reduction target linked to our economic contribution to GDP. In 2011 we reduced our carbon emissions intensity per unit of value added (our contribution to GDP) by 59% compared with 1997. We continue to make good progress towards our target of achieving an 80% reduction in our worldwide emissions intensity by 2020, compared with 1997. A description of our energy reduction progress and how it was achieved is included in the **BT Operate** section on page 35.

In 2007 we announced plans to develop our own onshore wind farms so that we can produce around 25% of our electricity from renewable resources by 2016. This has proved challenging in terms of securing planning permission. However, we have had one site agreed in North East England and others are in train.

Engaging with the UK Government

Through our actions and engagement with the UK Government, we are trying to encourage investment in low-carbon electricity generation. One way to help stimulate the creation of a clear market for renewable and low-carbon energy would be to introduce a colour-coded label on all electricity sold in the UK, enabling customers to easily assess the green credentials of the electricity they buy. Such a system has worked successfully in driving low-carbon purchasing decisions in other markets such as white goods and vehicles.

We believe this type of transparent carbon information, supported by tax incentives, would stimulate demand for green energy, and help the UK to move more quickly to a low-carbon energy market. It would also resolve the problem of double-counting of green electricity and remove the confusion surrounding current green tariffs .

BUSINESS REVIEW OUR CORPORATE RESPONSIBILITY

Engaging with vendors

In February 2011 we introduced a new procurement standard requiring all suppliers to measure and report their carbon and greenhouse gas emissions and set reduction targets. This is designed to encourage supplier innovation and to speed up development of low-carbon technologies. We ran workshops in partnership with the Carbon Trust this year to help 80 UK SMEs improve their understanding of climate change and develop action plans to reduce their impact.

Engaging with customers

Reports such as SMART2020 show that the ICT sector as a whole has the opportunity to help society reduce global carbon emissions by as much as 15% by 2020. We work with customers to help them to reduce their carbon emissions and energy consumption through the supply of energy-efficient products and solutions. We encourage business customers to replace travel with digital communications and in the UK we announced a smart metering consortium in partnership with Arquiva and Detica. These and other low-carbon opportunities are realised through our customer-facing lines of business and described in **BT Global Services** on page 23 and **BT Retail** on page 26.

Behaving responsibly

We strive to behave responsibly towards our customers, suppliers, employees and neighbours.

We expect everyone at BT to meet high ethical standards and we want to do business with suppliers and customers we can trust and who share our values.

We have a governance structure in place to monitor that our ethical policies reflect best practice and are routinely applied.

We are implementing an anti-corruption and bribery programme to build on our ethical culture. We have policies and procedures in place to mitigate the risk of any BT employee, or anyone acting on our behalf, breaching our ethical code of conduct.

Ethical performance measure an index measured on a five point scale of the success of BT's employee awareness and training.

Non financial performance

Target 2012	2011	2010	2009
Maintain or improve our 2011 index score	4.16	4.10	New in 2010

Financial performance**Revenue support**

Customer bids with a sustainability element	£2.1bn	£2.1bn	£1.5 bn
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We take our responsibilities as an ISP seriously. Using Cleanfeed – our content filtering solution – BT continues to prevent inadvertent access to images of child sexual abuse as identified by the Internet Watch Foundation. We have shared, without charge, the technical solution with other carriers. To supplement this, in March 2011 BT launched a new range of printed and online safety advice to help parents keep children safe on the internet. At the same time we launched a major campaign to prompt BT broadband customers to consider BT's free Family Protection parental-control software. The software is offered automatically as part of the install process.

BT is participating in research at the University of Cambridge, Massachusetts Institute of Technology and Tsinghua University, assessing how people react to technological change and how these changes affect the productivity and well-being of individuals and society as a whole.

BT's approach to privacy and data protection includes both technological solutions and a focus on employee awareness and behaviour. In 2011 we established a number of regional governance committees which oversee our approach and monitor progress.

Disaster response and resilience

Resilience is incorporated into the design of our network, but disasters and emergencies can strike unexpectedly. BT has formal legislative civil contingency responsibilities as a UK Category Two responder. As the largest guardian of Britain's telecommunications Critical National Infrastructure (CNI) we are responsible for maintaining communications for our customers, including other CPs, as well as national, regional and local government, emergency services and public sector bodies. We also aim to help shape and implement best practice.

We extend this core value of being a responsible business into our community investment focus through engagements with the Disaster Emergency Committee (DEC), the British Red Cross and the American Red Cross and via maintaining a dedicated emergency response team.

Our corporate responsibility risks

We quantify the most significant social, environmental and ethical risks to BT in our corporate responsibility risk register. This is updated twice a year and reviewed annually.

The current corporate responsibility risks which we monitor and report on are:

health and safety risks to employees and the public exposed to BT operations

breach of integrity or unintended release of private customer data leading to a loss of trust in BT

mitigating climate change impacts such as increased costs associated with changing legislation

adapting our business to reduce our exposure to the direct impacts of climate change, such as severe weather

ensuring that our activities and their outcomes meet legal or ethical standards for a diverse workforce

unacceptable supply chain working conditions.

Where appropriate, references are made within the **Our risks** section on page 39 to the aspects referred to above.

Further information

More detailed information about our CR and sustainability performance is available in our independently verified 2011 sustainability report at www.bt.com/betterfuture

BUSINESS REVIEW

OUR RISKS

Our approach to managing risk

Principal risks and uncertainties

Our risks

Security and resilience

Major contracts

Pensions

Growth in a competitive market

Communications industry regulation

Compliance in a global environment

Supply chain

Risk management is integral to our business and is central to the successful delivery of our objectives. Our risk management approach supports the creation and maintenance of shareholder value whilst promoting the interests of our many stakeholders through the safeguarding of our assets – people, property and resources – and of our reputation.

Our approach to managing risk

BT has in place group-wide risk management processes for the identification, evaluation, treatment and subsequent monitoring of risks which may significantly threaten the accomplishment of our objectives and long-term strategic aims. Our risk management processes are operated within BT lines of business (LoB), internal service units, group functions, contracts, projects and programmes and are aggregated at group level. The approach is defined in our group-wide risk management policies.

Management is responsible for identifying, evaluating, mitigating and monitoring risks. Those risks which are significant to the group are reported and monitored through the Group Risk Register (GRR) which is formally updated quarterly. The GRR includes those risks identified from across the group, which are significant as assessed on a quantitative and qualitative basis. Each risk, including those in the GRR, is assigned a management owner who is responsible for the ongoing monitoring of the risk including changes to the risk profile and progress of the mitigations. The Board has overall responsibility for ensuring that our risks are managed appropriately and, either directly or through its sub-committees, the *Operating Committee* and the *Audit & Risk Committee*, undertakes regular reviews of the management of the risks at group-wide, LoB, internal service units and group function levels.

The Board and the Operating Committee are supported in their oversight of risk management by the Group Risk Panel who review the GRR quarterly, consider new or emerging risks, make recommendations on the strength of mitigations and monitor the work of the Group Risk Management function. Our reporting is structured so that emerging key issues are escalated through management to the Board as appropriate.

Principal risks and uncertainties

In common with all businesses, BT is affected by a number of risks and uncertainties, some of which are not within our control. Many of our risks are similar to those of comparable companies in terms of scale and operation.

Economic uncertainty remains a major challenge to businesses globally and we remain conscious of those risks in all our business undertakings. Compliance in a global environment and supply chain are now recognised as principal risks along with those risks reported on last year which were: security and resilience; major contracts; pensions; growth in a competitive market and communications industry regulation.

This section highlights some of those particular risks and uncertainties affecting our business but it is not intended to be an extensive analysis of all risk and uncertainty affecting our business. These risks have the potential to impact our business, revenues, profits, assets, liquidity and capital resources adversely. Our processes are designed to give reasonable, but cannot give absolute, assurance that the risks significant to the group are identified and addressed. There may be risks which are unknown or which are presently judged not to be significant but later prove to be significant.

We have included comment on mitigations that we apply to help us manage the risks; however it is possible that not all of these mitigations will be successful. The principal risks and uncertainties should be considered in conjunction with the risk management process, the forward- looking statements for this document and the **Cautionary statement regarding forward-looking statements** on page 162.

BUSINESS REVIEW OUR RISKS

Our risks

Security and resilience

BT is dependent on the secure operation and resilience of its information systems, networks and data. The scale of our business and global nature of our operations means we are required to manage significant volumes of personal and commercially sensitive information.

BT stores and transmits data for its own purposes and on behalf of customers, all of which needs to be safeguarded from potential exposure, loss or corruption, and therefore receives a high level of management attention and security measures.

Certain of our customers require specific, highly sophisticated security provisioning which we are contractually obliged to meet and through our continuing success in meeting those requirements we are able to differentiate our offerings from those of our competitors.

Impact

Failure or interruption of data transfer could have a significant adverse effect on the business. A breach of our security and/or resilience affecting BT's own operations or those of our customers could lead to an extended interruption to network services and even national infrastructure. Such failure may lead to a loss of customer confidence, termination of contracts, loss of revenue and reduced cash resources. Additional reputational damage and financial loss may arise from a breach involving a legal failing such as breaching data protection requirements.

Risk mitigation

We operate well established policies addressing the security and resilience requirements of our operations, our systems and systems operated by us for our customers. We have a corporate resilience strategy and business continuity plans in place designed to deal with catastrophic events including, for example, major terrorist action, industrial action, cyber-attacks or natural disasters.

Our mitigations for this diverse risk are continuously reviewed and updated which, in 2011, led to more stringent application of data encryption and segregation measures, the deployment of increasingly sophisticated anomaly and intrusion detection systems, and migration to distributed and virtual data centre designs that provide much greater inherent resilience.

Major contracts

We have a number of complex and high value contracts with certain customers. The profitability of, and revenue arising from, these contracts is subject to a number of factors including: variation in cost and achievement of cost reductions anticipated in the contract pricing, both in terms of scale and time; delays in delivery or achieving agreed milestones owing to factors either within or outside of our control; changes in customers' requirements, budgets, strategies or businesses; the performance of our suppliers; and other factors. Any of these factors could make a contract less profitable or even loss making.

The degree of risk varies generally in proportion to the scope and life of the contract and is typically higher in the early transitional and transformational stages of the contract. Some customer contracts require significant investment in the early stages, which is expected to be recovered over the life of the contract. Major contracts often involve the implementation of new systems and communications networks, transformation of legacy networks and the development of new technologies. The recoverability of these upfront costs may be adversely impacted by delays or failure to meet milestones. Substantial performance risk exists in these contracts, and some or all elements of performance depend upon successful completion of the transition, development, transformation and deployment phases.

Impact

Failure to manage and meet our commitments under these contracts, as well as changes in customers' requirements, budgets, strategies or businesses may lead to a reduction in our expected future revenue, profitability and cash generation. We may lose significant revenues due to the merger or acquisition of customers, changes to customer strategy, business failure or contract termination. Failure to replace the revenue and earnings thereby lost from such

customers will lead to reduction in revenue, profitability and cash flow.

Risk mitigation

We have developed business processes in support of each stage of the major contract life cycle: bid, in life, renewal and termination. Our programme of in-life reviews has been enhanced over the past two years and is designed to validate financial and non-financial controls over delivery of the contracts and incorporates tiered levels of defined review according to the scale and complexity of the contract. All our contracts are subject to regular management review and many are subject to independent review (both internal and external) as part of that governance. Independent review helps us identify lessons learned and to promulgate best practice through the business.

BUSINESS REVIEW OUR RISKS

Pensions

We have a significant funding obligation to a defined benefit pension scheme. Declining investment returns, longer life expectancy and regulatory changes may result in the cost of funding BT's main defined benefit pension scheme (BTPS) becoming a significant burden on our financial resources. The triennial funding valuation of the BTPS at 31 December 2008 and associated recovery plan was agreed with the Trustee in February 2010. Under this prudent funding valuation basis the deficit was £9bn and a 17-year recovery plan was agreed. Details of the valuation assumptions and recovery plan are set out in note 23 to the financial statements.

The valuation and the recovery plan are under review by the Pensions Regulator whose initial view was that they had substantial concerns with certain features of the agreement. Their review is now on hold and is not expected to recommence until the outcome of the final Court decision, including any potential appeals, is known on the Crown Guarantee. Accordingly, as matters stand, it is uncertain as to when they will conclude their review. This uncertainty is outside of our control. However, we do not expect this to be before the completion of the next triennial funding valuation as at 31 December 2011. As is usual, BT and the Trustee will engage with the Pensions Regulator regarding the 2011 valuation.

Impact

An increase in the pension deficit and associated funding requirements would have a direct adverse impact on the future cash resources of the group. Indirectly it may also have an adverse impact on the group's share price and credit rating. A deterioration in the credit rating would increase the group's cost of borrowing and may limit the availability or flexibility of future funding thereby affecting the ability of the business to invest, pay dividends or repay debt as it matures.

Risk mitigation

Since the funding valuation at 31 December 2008 there have been a number of significant developments. With effect from 1 April 2009 a number of benefit changes were implemented which reduce the cost of future benefit accruals and the associated risks. During 2011 the UK Government decision to change the indexation of pension benefits from the Retail Prices Index to the Consumer Prices Index has affected some sections of the BTPS and resulted in a significant reduction in the liabilities and associated risks.

The returns generated on the assets since 31 December 2008 have also been significantly greater than assumed in the funding valuation. As a result the Trustee's initial estimate is that the funding valuation had reduced to £3.2bn at 31 December 2010 after the deficit payment of £0.5bn in March 2011. We took the opportunity to accelerate the deficit payment due in December 2011 to March 2011 as it was economically advantageous to do so.

The investment performance and liability experience as well as the associated risk exposures are regularly reviewed and monitored by both the company and the Trustee of the scheme.

Growth in a competitive market

We operate in markets which are characterised by high levels of competition including: regulatory intervention on promoting competition; declining prices; technology substitution; market and service convergence; customer churn; declining rates of market growth; and emerging competitors with non replicable sources of competitive advantage. A significant proportion of our revenue and profit are generated in the UK telecommunications markets which are experiencing limited growth in revenue terms and in many cases are highly competitive. Revenue from our fixed line calls and lines services to consumers and businesses have historically been in decline. Our ability to deliver profitable revenue growth depends on delivering on our strategic priorities (see page 11).

Impact

Failure to achieve profitable revenue growth through our strategic priorities (see **Our business and strategy** on pages 10 to 13 for further details) may lead to a continued decline in revenue, erosion of our competitive position and might also lead to a reduction in future profitability, cash flow and to a diminution in shareholder value.

Risk mitigation

We have a clearly defined strategy aimed at delivering growth, as set out on pages 10 to 13, the successful delivery of which will address the need for growth in revenue.

Our strategic priorities are underpinned by our view of the markets in which we operate. Performance against our business plans is closely monitored by management allowing interventions where appropriate.

The group has a well developed cost transformation programme in place which has achieved significant savings and which has from a profitability perspective mitigated the revenue declines and helped ensure a competitive cost base.

BUSINESS REVIEW OUR RISKS

Communications industry regulation

Some of our activities continue to be subjected to significant price and other regulatory controls which may affect our market share, competitive position, future profitability and cash resources. Many of our wholesale fixed network activities in the UK are subject to significant regulatory controls. The controls regulate, among other things, the prices we can charge for many of our services and the extent to which we have to provide services to other CPs. In recent years the effect of these controls has required us to reduce our prices, although in some recent cases, prices have been allowed to increase in real terms.

Regulatory authorities may increase the severity of the price controls, extend the services to which controls apply or extend the services which we provide to other CPs. These controls may adversely affect our market share, our ability to compete and our future profitability and cash resources. Wholesale customers may also raise disputes with Ofcom, seeking lower prices on wholesale services which are not subject to direct price control.

Impact

In recent years, changes in price controls have required us to reduce our prices and in some instances to make payments in respect of retrospective price adjustments. Additional or more substantial regulatory price reductions could constrain our revenue growth. Regulatory actions may also indirectly affect us. For example, Ofcom has reduced the mobile termination rates that mobile network operators can charge to terminate calls on their network. There will be a stepped reduction in prices over four years starting from April 2011. This regulatory action will have a significant impact on future transit revenues in the UK and Europe.

We may be required to provide new services to wholesale customers on a non-discriminatory basis, increasing our costs and increasing retail competition. Disputes may result either in reduced revenue or increased costs going forward. We may also be required to make retrospective payments to CPs if it is ruled that past charging mechanisms we have applied have overcharged CPs. Appeals may change Ofcom's decisions, which had originally been concluded in our favour.

Risk mitigation

We continuously monitor and review potential regulatory changes and disputes, and maintain a strategic dialogue with regulators and other key influencers on critical issues.

Compliance in a global environment

Some of the countries where we operate have increased their enforcement of local laws and therefore the potential impact of failing to comply with local and international legislative requirements has increased significantly.

Legislation is increasingly multi jurisdictional and the potential penalties, including fines, that have been levied against a number of organisations, have grown in frequency and value.

Legal compliance obligations include antitrust and anti-corruption legislation, competition law, data privacy, trade sanctions, import and export controls, taxation and telecommunications regulatory requirements. The UK Bribery Act which comes into effect in July 2011 with increased penalties for non-compliant businesses introduces the offence of failing to prevent bribery. With the breadth of BT's operations and complex commercial relationships we must ensure that we and our business partners are compliant as a continuing priority.

Impact

Failure to comply with legal requirements can have a significant impact and lead to a loss of reputation and damage to our brand with investors, regulators and customers. Non-compliance with legislation, including requirements to maintain adequate systems and controls, may also lead to prosecution, penalties and in some cases could lead to litigation and loss of revenues and loss of profits.

Failure by our employees, suppliers or agents to comply with anti-bribery and corruption legislation (including the US Foreign Corrupt Practices Act and the UK Bribery Act), or any failure in our policies and procedures to monitor and prevent non-compliance, anywhere in the world, could result in substantial penalties, criminal prosecution and

significant damage to our reputation.

Risk mitigation

We have in place a number of established controls to address this risk including: a clear and comprehensive code of conduct, *The Way We Work*, which is part of the mandatory training of all employees; compliance policies; global training programmes promoting adherence to applicable laws; a BT Ethics programme introduced to increase the due diligence of our suppliers, contractors, agents and business consultants; and a programme of assurance within the business. On a regular basis, we also review our anti-corruption and bribery measures and are implementing additional procedures.

BUSINESS REVIEW OUR RISKS

Supply chain

We are dependent upon our supply chain for the delivery of goods and services on time, to cost and specification. A number of factors, including the continuing economic uncertainty have contributed to a heightening of the risk of this reliance. Failure of any of our critical suppliers to meet agreed deliverables could adversely impact our customer service, product launch, business critical systems updates, revenues or cost efficiency.

BT is committed to ensuring that all dealings with suppliers, from selection and consultation, to contracting and payment are conducted in accordance with our trading and ethical policies.

Our supply chain is truly global and we aim to harness the capability, diversity and innovation of our supply market to add value to our business and customers. Many suppliers are being impacted by the economic downturn and the challenges of globalisation. This is introducing further risk in our supply chain which includes, but is not limited to: increase in supplier insolvency; lack of supplier resilience following a disaster; corporate social responsibility risks in our extended supply chain; and security risks relating to data protection.

Impact

Our suppliers could be adversely affected by economic conditions which in turn could impact their ability to meet their obligations to us or, in the extreme, cause them to fail. If we are unable to contract with an alternative supplier our customer commitments could also be compromised leading to contractual breach, loss of revenue, penalties or increased costs.

A failure in our supply chain to meet legal obligations or ethical expectations could adversely impact our reputation or possibly lead to censure, legal action and financial loss.

Risk mitigation

We continue to mitigate this risk through a number of measures including: globally coordinated vendor management programmes; rigorous bid controls; supplier risk assessments including focus on our most critical suppliers; our Procurement Academy Programme, an internal training initiative; anti-corruption and bribery awareness training; and CR and Compliance Health Checks. We work with our suppliers to ensure that the goods and services that we buy are made, delivered and disposed of in a socially and environmentally responsible manner.

FINANCIAL REVIEW

45 INTRODUCTION FROM THE GROUP FINANCE DIRECTOR

46 FINANCIAL PERFORMANCE

46 Summarised income statement

46 Group results

46 Outlook

46 Revenue

47 Other operating income

47 Transforming our cost base

48 Adjusted EBITDA

49 Operating profit

49 Net finance expense

49 Associates and joint ventures

49 Profit before taxation

49 Taxation

49 Adjusted earnings per share

50 Dividends

50 LIQUIDITY

50 Free cash flow

50 Summarised cash flow statement

51 Taxation

52 FUNDING AND CAPITAL MANAGEMENT

52 Capital management and funding policy

54 Contractual obligations and commitments

54 Off-balance sheet arrangements

54 Quantitative and qualitative disclosures about interest, foreign exchange, credit and liquidity risks

54 Going concern

54 FINANCIAL POSITION AND RESOURCES

54 Summarised balance sheet

56 Acquisitions and disposals

56 Legal proceedings

56 Principal accounting policies, critical accounting estimates and key judgements

56 ALTERNATIVE PERFORMANCE MEASURES

56 Introduction

56 Specific items

57 EBITDA

57 Adjusted earnings per share

58 Free cash flow

58 Net debt

FINANCIAL REVIEW

INTRODUCTION FROM THE GROUP FINANCE DIRECTOR

How we performed in 2011

2011 performance against our financial outlook

In May 2010 we set out our financial objectives for the three-year period to 2013. We said we expected to improve our revenue trends and to grow EBITDA and free cash flow, while investing in the business, reducing net debt, supporting the pension fund and paying progressive dividends.

In 2011 we have made good progress towards achieving these objectives and have delivered full year results in line with or ahead of our outlook for the year. Market conditions remain challenging, with the UK telecoms market being one of the most competitive in the world. However, we have delivered some significant milestones in 2011 and have exited the year in the right place to continue to deliver against our financial objectives over the next two years.

Revenue trends

Revenue declined by 4% to just over £20bn in 2011. Excluding foreign exchange movements and the reduction in low-margin transit revenue which includes the impact of mobile termination rate reductions, underlying revenue excluding transit was down 3% in 2011.

Growing EBITDA and earnings per share

The execution of our cost transformation programmes have helped deliver over £1bn of operating cost reductions in 2011, ahead of our outlook for the year. Overall, adjusted EBITDA grew by 4% to £5,886m in 2011, also ahead of our outlook for the year.

Higher operating profit and lower finance expense increased adjusted earnings per share by 21% to 21.0p in 2011.

Growing free cash flow

We generated adjusted free cash flow of £2.2bn in 2011, well ahead of our initial outlook of around £1.8bn for the year. This reflects our improved profitability and working capital performance and is after investing £2.6bn in capital expenditure. BT Global Services achieved their operating cash flow positive milestone a year ahead of expectations.

Investing in the business

The savings we have made in operating costs and working capital improvements have enabled us to invest in the future of our business both in terms of capital and operating expenditure. Our fibre roll-out is one of the most rapid in the world and we are on track to pass 5m premises by spring 2011. We have significantly increased the number of customers enjoying next generation broadband services and have invested in reducing the number of faults in our network and getting things right first time for our customers.

Reducing net debt and supporting the pension fund

Net debt has reduced by £467m to £8,816m, in line with our outlook to be below £9bn by 31 March 2011. This is after making pension deficit payments of £1,030m, including £505m brought forward from December 2011. We also repaid maturing debt of £2.5bn from our existing cash and investment balances and agreed a new five-year £1.5bn committed facility. There are no further significant debt maturities until 2013. The IAS 19 net pension position has significantly reduced by £4.3bn to a deficit of £1.4bn, net of tax, at 31 March 2011.

Progressive dividends

As we stated in 2010, the Board is committed to paying progressive dividends, whilst balancing the need to invest in the business, reduce our net debt and support the pension fund. Taking these considerations into account, the Board is proposing a full year dividend of 7.4p, up 7%.

Outlook

We expect underlying revenue excluding transit to grow in 2013. Adjusted EBITDA is expected to show further growth in 2012 and to be above £6.0bn in 2013. We expect adjusted free cash flow to be above the 2011 level in 2012 and 2013, with BT Global Services generating operating cash flow of around £200m in 2012.

Tony Chanmugam

Group Finance Director

11 May 2011

How we performed in 2011

	Outlook May 2010	Result	
Revenue	c.£20bn	£20.1bn	ü
Operating cost savings	c.£900m	£1.1bn	ü
Adjusted EBITDA^a	in line with 2010 ^b	£5.9bn	ü
Adjusted free cash flow^{a,c}	c.£1.8bn ^b	£2.2bn	ü
Net debt^a	<£9bn	£8.8bn	ü

^a Adjusted EBITDA, adjusted free cash flow and net debt are non-GAAP measures. See pages 56 to 58 for details.

^b Adjusted EBITDA and adjusted free cash flow outlook updated in November 2010 to be around £5.8bn and £2bn.

^c Before pension deficit payments.

FINANCIAL REVIEW
FINANCIAL PERFORMANCE
Summarised income statement

	Year ended 31 March 2011		
	Before specific items £m	Specific items £m	Total £m
Revenue	20,076		20,076
Other operating income	373		373
Operating costs excluding depreciation and amortisation	(14,563)	(329)	(14,892)
EBITDA	5,886	(329)	5,557
Depreciation and amortisation	(2,979)		(2,979)
Operating profit	2,907	(329)	2,578
Net finance expense	(845)	(79)	(924)
Share of post tax profits of associates and joint ventures	21		21
Profit (loss) on disposal of interest in associate		42	42
Profit (loss) before taxation	2,083	(366)	1,717
Taxation (expense) credit	(452)	239	(213)
Profit (loss) for the year	1,631	(127)	1,504

Group results

In this Financial review we discuss the financial results of the group for 2011, 2010 and 2009. We explain financial performance using a variety of measures. In particular, in this **Financial review**, we principally discuss the group's results on an adjusted basis being before specific items. The rationale for using adjusted measures is explained on page 56. A definition of specific items is set out on page 56. Specific items for 2011, 2010 and 2009 are disclosed in note 8 to the consolidated financial statements and summarised on pages 56 to 57 of this **Financial review**. In 2011 net interest on pensions has been included in specific items because of its volatile nature, and also the BT Global Services contract and financial review charges in 2009 by virtue of their size and nature. Accordingly, specific items for comparative periods have been re-presented to reflect this reclassification.

We also explain financial performance using measures that are not defined under IFRS and are therefore termed non-GAAP measures. The non-GAAP measures we use in this **Financial review** are adjusted and reported EBITDA, adjusted and reported free cash flow and net debt. Each of these measures is discussed in more detail on pages 56 to 58.

In this **Financial review**, references to 2011, 2010 and 2009 are to the financial years ended 31 March 2011, 2010 and 2009, respectively. References to the year and the current year are to the year ended 31 March 2011.

Outlook

We are focusing on long-term profitable revenue growth. Underlying revenue excludes the impact of foreign exchange movements, acquisitions and disposals and specific items. As transit traffic is low-margin and significantly impacted by regulatory reductions in mobile termination rates, with no impact on the group's profitability, we have excluded

transit from our key measure of the underlying revenue performance of the group. Transit revenue declined by £214m in 2011, and we expect it to decline by around a further £400m in 2012 and £200m in 2013, largely due to mobile termination rate reductions. Underlying revenue, excluding transit was down 3% in 2011 and we expect it to be in the range down 2% to flat in 2012 and to grow by up to 2% in 2013.

Adjusted EBITDA is expected to show further growth in 2012 and to be above £6.0bn in 2013. We expect adjusted free cash flow to be above the 2011 level in 2012 and 2013, with BT Global Services generating operating cash flow of around £200m in 2012.

Revenue

In 2011 revenue decreased by 4% (2010: 2% decrease). Excluding the negative impact of foreign exchange movements and the reduction in low-margin transit revenue, underlying revenue excluding transit was down 3%.

Products and services revenue

Our products and services include telecommunications services provided in the UK and also a wide range of products and services provided globally. These are designed to meet the demand for IT infrastructure and solutions and satisfy the expansion of broadband.

46

FINANCIAL REVIEW FINANCIAL PERFORMANCE

Year ended 31 March 2010			Year ended 31 March 2009		
Before specific items £m	Specific items £m	Total £m	Before specific items £m	Specific items £m	Total £m
20,911	(52)	20,859	21,431	(41)	21,390
378	2	380	352	(13)	339
(15,650)	(427)	(16,077)	(16,545)	(1,993)	(18,538)
5,639	(477)	5,162	5,238	(2,047)	3,191
(3,039)		(3,039)	(2,890)		(2,890)
2,600	(477)	2,123	2,348	(2,047)	301
(890)	(268)	(1,158)	(933)	313	(620)
25	29	54	39	36	75
	(12)	(12)			
1,735	(728)	1,007	1,454	(1,698)	(244)
(398)	420	22	(361)	414	53
1,337	(308)	1,029	1,093	(1,284)	(191)

Our products and services are sold separately or as part of solutions whereby they work together as a unified offering. An analysis of revenue by major product and service category is set out below:

	2011 £m	2010 £m	2009 £m
Products and services			
ICT and managed networks	6,632	6,574	6,382
Broadband and convergence	2,767	2,677	2,618
Calls and lines	5,595	6,225	6,799
Transit	1,518	1,758	2,003
Conveyance, interconnect circuits, WLR, global carrier and other wholesale	1,471	1,451	1,506
Other products and services	2,093	2,226	2,123
Revenue	20,076	20,911	21,431

Descriptions of products and services provided by individual lines of business is included in **Our lines of business** on pages 23 to 35.

ICT and managed networks

In 2011 ICT and managed networks revenue increased by 1% (2010: 3% increase). This growth was mainly due to a continuation of the trends from 2010 with an increase in MNS revenue in BT Wholesale and growth in networked IT services revenue in BT Global Services.

Broadband and convergence

In 2011 broadband and convergence revenue increased by 3% (2010: 2% increase) due to the continued growth in broadband revenue in BT Retail and the increase in LLU revenue in Openreach. This was offset by a decline in broadband revenue in BT Wholesale, reflecting the trend of CPs continuing to switch to LLU provided by Openreach and due to BT Wholesale securing volumes under long term MNS contracts.

Calls and lines

In 2011 calls and lines revenue decreased by 10% (2010: 8% decrease). The continuing decline reflects the challenging market conditions, particularly in the business sector, and the migration from fixed-line calls to broadband, data and IP services.

Transit

In 2011 transit revenue decreased by 14% (2010: 12%). The decrease in both years is due to the impact of regulatory mobile termination rate reductions and the continued decline in low margin transit volumes.

Conveyance, interconnect circuits, WLR, global carrier and other wholesale products

In 2011 revenue from conveyance, interconnect circuits, WLR, global carrier and other wholesale products was broadly flat (2010: 4% decrease).

Other products and services

Other products and services revenue principally comprises BT Global Services revenue from non UK global products and revenue from BT Retail's Enterprises division including BT Conferencing, BT Directories and BT Redcare & Payphones. In 2011 revenue from other products and services decreased by 6% (2010: 5% decrease).

Other operating income

Other operating income was £373m in 2011, broadly flat compared with 2010 (2010: 7% increase). The increase in 2010 was principally due to an increase in the profit on sales of scrap and cable recoveries due to increased copper market prices and supplier settlements.

Transforming our cost base

In 2011 we have continued our programme of cost transformation and delivered cost savings of £1,087m, a 7% reduction (2010: 5% reduction). The key drivers of this reduction have been vendor negotiations and price reductions and the transformation and re-engineering of our business activities, delivering improvements in the efficiency and effectiveness across the group.

FINANCIAL REVIEW FINANCIAL PERFORMANCE

^aOperating cost reductions exclude specific items and depreciation and amortisation.

^bIncludes net labour costs, property and energy costs, network maintenance and IT costs and general and administrative costs.

Operating costs

Operating costs before specific items are shown below:

Year ended 31 March	2011 £m	2010 £m	2009 £m
Staff costs			
Wages and salaries	3,947	4,182	4,499
Social security costs	456	447	432
Pension costs	416	304	544
Share-based payments	68	71	141
Total staff costs	4,887	5,004	5,616
Own work capitalised	(718)	(575)	(673)
Net staff costs	4,169	4,429	4,943
Indirect labour costs	629	722	1,114
Net labour costs	4,798	5,151	6,057
Payments to telecommunications operators	3,740	4,083	4,266
Property and energy costs	1,149	1,284	1,292
Network maintenance and IT costs	706	781	742
Other operating costs	2,786	2,927	2,710
General and administrative costs	1,384	1,424	1,478
Operating costs before depreciation and amortisation	14,563	15,650	16,545
Depreciation	2,288	2,304	2,249
Amortisation	691	735	641

Operating costs	17,542	18,689	19,435
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Staff costs

Wages and salaries decreased by 6% to £3,947m (2010: 7% decrease), largely due to the impact of labour resource reductions and efficiencies and lower leaver costs, partly offset by pay inflation and increased overtime. Leaver costs, included within wages and salaries, were £57m (2010: £142m, 2009: £204m).

The pension charge for 2011 was £416m, compared with £304m in 2010 and £544m in 2009. The increase in the pension cost in 2011 reflects the lower discount rate and higher inflation assumptions at the start of the year. The decrease in the pension cost in 2010 reflects the impact of the changes to benefit accruals in BTPS with effect from 1 April 2009, partly offset by an increase in social security costs as BTPS ceased to contract out of the State Second Pension.

Share-based payment costs remained broadly flat at £68m (2010: £71m) in 2011. In 2010 share-based payment costs decreased by 50% reflecting the significant forfeiture cost associated with the high number of the Sharesave cancellations which took place in 2009.

Indirect labour costs

Indirect labour costs decreased by 13% to £629m (2010: 35% decrease) as the group continued to reduce agency and contractor resource and redeploy existing permanent staff to protect jobs where possible.

Payments to telecommunications operators

Payments to telecommunications operators decreased by 8% to £3,740m (2010: 4% decrease). The decrease in 2011 and 2010 reflects the impact of mobile termination rate reductions and lower volumes, with the decrease in 2010 partly offset by unfavourable foreign exchange movements.

Property and energy costs

Property and energy costs decreased by 11% to £1,149m (2010: 1% decrease) mainly reflecting efficiency savings and lower energy prices.

Network maintenance and IT costs

Network maintenance and IT costs decreased by 10% to £706m (2010: 5% increase). The decrease in 2011 is mainly due to vendor savings and lower volumes as a result of lower revenue, whilst the increase in 2010 was mainly due to higher volumes, partly offset by vendor and efficiency savings.

Other operating costs

Other operating costs decreased by 5% to £2,786m (2010: 8% increase). This reduction is mainly due to lower revenue related costs as well as efficiency and vendor savings. The 2010 increase was largely due to unfavourable foreign exchange movements and the impact of acquisitions.

General and administrative costs

General and administrative costs decreased by 3% to £1,384m (2010: 4% decrease). The decrease in 2011 and 2010 reflects tight control of discretionary expenditure, lower consultancy costs, bad debts and foreign exchange.

Depreciation and amortisation

Depreciation and amortisation decreased by 2% to £2,979m (2010: 5% increase), reflecting lower levels of capital expenditure over the last two years, partly offset by increased expenditure on shorter lived assets.

Adjusted EBITDA

In 2011 adjusted EBITDA was £5,886m, an increase of 4% (2010: 8%). The increase in 2011 and 2010 reflects the benefits of the group-wide cost transformation activities and the improvement in the performance of BT Global Services.

Adjusted EBITDA for the last five financial years is included in **Selected financial data** on page 159.

FINANCIAL REVIEW FINANCIAL PERFORMANCE**Operating profit**

In 2011 adjusted operating profit was £2,907m, an increase of 12% (2010: 11%) reflecting the improved EBITDA and lower depreciation and amortisation. Reported operating profit was £2,578m in 2011, compared with £2,123m in 2010 and £301m in 2009.

Net finance expense

Net finance expense before specific items, (principally comprising net pension interest) is shown below. Net pension interest is discussed in note 23 to the consolidated financial statements.

	2011	2010	2009
	£m	£m	£m
Interest on borrowings	852	886	935
Fair value movements on derivatives	34	19	29
Finance expense	886	905	964
Less: capitalised interest	(6)	(3)	
Total finance expense	880	902	964
Interest income	(35)	(12)	(31)
Total finance income	(35)	(12)	(31)
Net finance expense	845	890	933

Finance expense

Interest on borrowings in 2011 was £852m, a decrease of 4% (2010: 5%) reflecting reductions in net debt and the repayment of higher coupon debt in the year. In 2011 the fair value movement on derivatives of £34m (2010: £19m) includes £28m (2010: £9m) of swap restructuring costs on certain derivatives and £6m (2010: £10m) of fair value movements on derivatives not in a designated hedge relationship.

The graph below shows the relationship between average gross debt and interest rates over the three-year period.

Finance income

Interest income arising from listed investments and other interest and similar income was £35m in 2011, an increase of £23m (2010: £12m, a decrease of £19m). The increase in 2011 includes £19m of interest in respect of a tax refund. Excluding the refund, interest in 2011 was £4m higher than in 2010 as a result of higher cash balances in anticipation of funding the debt maturities in the second half of the financial year. The reduction in 2010 was principally due to lower market interest rates on deposits held.

Associates and joint ventures

Our share of the post tax profit from associates and joint ventures was £21m in 2011 (2010: £25m, 2009: £39m). Our most significant associate is Tech Mahindra, which contributed £22m of post tax profits in 2011 (2010: £25m, 2009: £33m). The decrease in 2011 is primarily due to the disposal of a 6.5% interest in Tech Mahindra in 2011, taking our holding to 23.5%.

Profit before taxation

Adjusted profit before taxation was £2,083m in 2011, an increase of 20% (2010: 19% increase). The increase in 2011 and 2010 reflects the improvement in the group's operating profit and the reduction in net finance expense.

Reported profit before taxation was £1,717m in 2011, compared with a profit before taxation of £1,007m in 2010 and a loss before taxation of £244m in 2009.

Taxation

The tax charge for 2011 was £213m and comprised a tax charge of £452m on the profit before taxation and specific items of £2,083m, and a credit of £239m on specific items. The effective rate on the profit before taxation and specific items was 21.7% compared with the statutory rate of 28%, reflecting the utilisation of tax losses and the continued focus on tax efficiency within the group.

The tax credit for 2010 was £22m (2009: £53m) and comprised a tax charge of £398m (2009: £361m) on the profit before taxation and specific items of £1,735m (2009: £1,454m) and a credit of £420m (2009: £414m) on specific items. The effective rate on the profit before taxation and specific items was 22.9% (2009: 24.8%) compared with the statutory rate of 28%, reflecting the utilisation of tax losses and the continued focus on tax efficiency within the group. For further details on taxation, see **Taxation** on page 51.

Adjusted earnings per share

Adjusted earnings per share is one of the group's key performance indicators, as detailed in **Our strategy** **Key performance indicators** on page 6. It is an important measure of the overall profitability of our business.

Adjusted earnings per share was 21.0p in 2011, an increase of 21% (2010: 23% increase). The graph below shows the drivers of adjusted earnings per share growth over the last two years.

^a Adjusted earnings per share is stated before specific items. See page 57 for further details.

^b Other includes interest, tax and share of post tax profits of associates and joint ventures.

Adjusted earnings (loss) per share for last five financial years are included in **Selected financial data** on page 158.

FINANCIAL REVIEW FINANCIAL PERFORMANCE/LIQUIDITY

Dividends

The Board is committed to progressive dividends, while balancing the need to invest in the business, reduce our net debt and support the pension fund.

The total dividend proposed for 2011 is 7.4p per share, an increase of 7% (2010: 6%) and totalling £574m (2010: £534m, 2009: £503m).

The final dividend proposed is 5.0p per share, an increase of 9%, amounting to approximately £388m (2010: £356m, 2009: £85m). This will be paid, subject to shareholder approval, on 5 September 2011 to shareholders on the register on 12 August 2011.

A table setting out the interim, final and total cash dividends paid, or in the case of the final dividend for 2011, proposed, for the last five financial years is included in **Information for shareholders** on page 164.

LIQUIDITY

Free cash flow

The major sources of the group's liquidity for 2011, 2010 and 2009 were the cash generated from the group's operations and borrowing through short-term and long-term issuances in the capital markets. These, as well as committed bank facilities, are expected to remain the key sources of liquidity for the foreseeable future.

In 2011 adjusted free cash flow was £2,223m, nearly trebling compared with £772m in 2009. Adjusted free cash flow is defined on page 58.

^a Before pension deficit payments.

^b Before specific items.

Reported free cash flow is one of the group's key performance indicators as detailed in **Our strategy Key performance indicators** on page 6. It is an important measure by which our financial performance is measured, as it represents the cash we generate from operations after capital expenditure and financing costs. It reflects the cash available to invest in the business, repay debt, support the pension scheme and pay dividends.

The graph below shows how we have used the cash generated from our business in 2011.

^a Net cash inflow from operating activities before pension deficit payments of £1,030m.

^b Other includes purchase of non-current asset investments and dividends from associates and joint ventures.

^c Other mainly includes foreign exchange movements.

A reconciliation from net cash inflow from operating activities, the most directly comparable IFRS measure, to reported free cash flow and adjusted free cash flow is provided on page 58. Reported free cash flow for the last five financial years is included in **Selected financial data** on page 159.

Summarised cash flow statement

	2011	2010	2009
	£m	£m	£m
Cash generated from operations	4,775	4,476	4,934
Net income taxes (paid) received	(209)	349	(228)
Net cash inflow from operating activities	4,566	4,825	4,706
Pension deficit payments	1,030	525	
Net capital expenditure	(2,630)	(2,480)	(3,038)
Purchase of non-current asset investments	(18)		
Dividends from associates and joint ventures	7	3	6
Interest paid	(973)	(956)	(956)
Interest received	29	16	19
Reported free cash flow	2,011	1,933	737
Pension deficit payments	(1,030)	(525)	
Acquisitions and disposals	64	(68)	(227)
Net sale (purchase) of current financial assets	365	(246)	286
Net (repayment) receipt of borrowings	(1,991)	(497)	522
Dividends paid	(543)	(265)	(1,222)
Net issue (purchase) of treasury shares	8	4	(209)
Foreign exchange	(3)	(7)	54
Net (decrease) increase in cash and cash equivalents	(1,119)	329	(59)
Cash and cash equivalents at the start of the year	1,444	1,115	1,174
Cash and cash equivalents at the end of the year	325	1,444	1,115

FINANCIAL REVIEW LIQUIDITY

Cash flow

Cash generated from operations

In 2011 cash generated from operations was £4,775m, an increase of 7%. This reflects improvements in profitability and working capital, offset by pension deficit payments of £1,030m (2010: £525m, 2009: £nil) which included the early payment of the £525m deficit payment due in December 2011. The level of working capital improvement is not expected to be repeated in 2012.

Net income taxes (paid) received

In 2011 the group paid tax of £209m. In 2010 the group received a net tax repayment of £349m. This comprised tax payments of £76m offset by a tax repayment of £215m, following the agreement of substantially all outstanding tax matters with HMRC, and a repayment of £210m in respect of overpaid corporation tax made in 2009. In 2009 the group paid tax of £228m. For further details see **Taxation** below.

Net capital expenditure

In 2011 net cash outflow on capital expenditure was £2,630m (2010: £2,480m, 2009: £3,038m) which comprised a cash outflow of £2,645m (2010: £2,509m, 2009: £3,082m) offset by cash proceeds from disposals of £15m (2010: £29m, 2009: £44m). Further details on capital expenditure are provided on page 55.

Interest

Interest paid in 2011 was £973m, compared with £956m in 2010, an increase of £17m primarily reflecting higher interest on bonds with step-up coupons, following a downgrade by Standard & Poor's (S&P) in February 2010. Interest received in 2011 was £29m, compared with £16m in 2010. Excluding interest on tax refunds in both years, interest received was £5m higher in 2011 as a result of higher cash balances in anticipation of funding the debt maturities in the second half of the financial year.

Acquisitions and disposals

There were no significant acquisitions in 2011 or 2010. In 2009, the net cash outflow principally comprised the acquisitions of Wire One Holdings Inc, Ufindus Ltd, Ribbit Corporation and Moorhouse Consulting Ltd. In 2011 the group disposed of a 6.5% interest in its associate Tech Mahindra for cash proceeds of £67m.

Net sale (purchase) of current and non-current financial assets

The cash flows in each financial year relate principally to changes in the amounts held in liquidity funds on a short-term liquidity management basis.

Net (repayment) receipt of borrowings

During 2011 borrowings amounting to £2,509m matured, principally consisting of bonds of £2,500m which were funded through existing cash and investments. This was partly offset by £340m from bank loans. In 2010 the group raised a 600m Euro bond at 6.125% repayable in 2014 which was swapped into £520m at a fixed semi-annual rate of 6.8%. In 2009 the group raised debt of £795m mainly through its European Medium Term Note programme and received £606m from the net issue of commercial paper. This was partially offset by the repayment of maturing borrowings and lease liabilities amounting to £879m.

Net purchase of shares

In 2011 9m shares were issued out of treasury to satisfy obligations under employee share schemes and executive share awards, receiving consideration of £8m (2010: £4m, 2009: £125m).

There were no purchases of shares in 2011 and 2010. In 2009 143m shares were repurchased for cash consideration of £334m.

Taxation

Total tax contribution

BT is a significant contributor to the UK Exchequer, collecting and paying taxes of around £3bn in a typical year. In 2011 we collected and paid £1,392m of VAT, £1,146m of PAYE and National Insurance, £175m of UK corporation tax for the current year and £176m of UK business and UK network rates.

Our total UK Exchequer tax contribution as measured in the Hundred Group Total Tax Contribution Survey for 2010 ranked BT the 5th highest contributor.

Tax strategy

Our strategy is to comply with relevant regulations whilst minimising the tax burden for BT and our customers. We seek to achieve this through engagement with our stakeholders including HMRC and other tax authorities, partners and customers.

The Board considers that it has a responsibility to minimise the tax burden for the group and its customers. In this respect the Board considers it entirely proper that BT endeavours to structure its affairs in a tax efficient manner where there is strong commercial merit, especially in support of customer initiatives, with the aim of supporting our capital or operational expenditure programmes and reducing our overall cost of capital. This planning is carried out within Board defined parameters. The Board regularly reviews the group's tax strategy.

We operate in over 170 countries and this comes with additional complexities in the taxation arena.

The majority of tax issues arise in the UK with a small number of issues arising in our overseas jurisdictions. In terms of the group's UK corporation tax position, all years up to 2008 are agreed. The UK corporation tax returns for 2010 were all filed prior to the statutory deadline.

We have an open, honest and positive working relationship with HMRC. We are committed to prompt disclosure and transparency in all tax matters with HMRC. We recognise that there will be areas of differing legal interpretations between ourselves and tax authorities and where this occurs we will engage in proactive discussion to bring matters to as rapid a conclusion as possible.

FINANCIAL REVIEW LIQUIDITY/FUNDING AND CAPITAL MANAGEMENT

We have a policy to lobby the UK Government directly on tax matters that are likely to impact our customers or shareholders and to respond to consultation documents where the impact could be substantial. We also lobby the UK Government indirectly through the CBI, various working groups and committees and leading professional advisors.

Tax accounting and cash flow

At each financial year end an estimate of the tax charge is calculated for the group and the level of provisioning across the group is reviewed in detail. As it can take a number of years to obtain closure in respect of some items contained within the corporation tax returns it is necessary for us to reflect the risk that final tax settlements will be at amounts in excess of our submitted corporation tax computations. The level of provisioning involves management judgement and estimation.

The UK Government reduced the rate of corporation tax by 2% to 26%, effective from 1 April 2011. This has resulted in a deferred tax credit of £172m in the income statement which has been classified as a specific item. The UK Government has also indicated that it intends to enact future reductions in the corporation tax rate at 1% per annum down to 23% by 1 April 2014.

The tax expense and the cash tax paid in each financial year are different, principally because UK cash tax payments are paid in quarterly instalments which straddle two consecutive financial years. For example, the cash tax paid in 2011 comprised the first two quarterly instalments in respect of 2011 and the last two instalments in respect of 2010. In addition there are differences in the basis of some items, such as pension deficit payments, which are deductible for the purpose of cash tax payments but are not a charge to the income statement and therefore do not impact the tax expense.

The total tax expense for 2011 was £213m and cash tax payments were £209m. Whilst the net difference is insignificant, there are some significant differences. These include the £172m deferred tax credit recognised in the income statement as described above and the current tax deduction available on our pension deficit payments of £1,030m.

The total tax credit for 2010 was £22m and a net tax refund of £349m was received which comprised payments of £76m offset by tax repayments of £425m relating to prior years. The total tax credit in 2009 was £53m and cash tax payments were £229m, of which £210m was repaid in 2010.

Tax losses

The group has unrecognised tax losses of £23.5bn, of which £17.8bn are capital losses arising in the UK, as set out in note 24 to the consolidated financial statements.

FUNDING AND CAPITAL MANAGEMENT

Capital management and funding policy

The objective of the group's capital management policy is to reduce net debt over time whilst investing in the business, supporting the pension scheme and paying progressive dividends. In order to meet this objective the group may issue or repay debt, issue new shares, repurchase shares or adjust the amount of dividends paid to shareholders. The group manages the capital structure and makes adjustments to it in the light of changes in economic conditions and the risk characteristics of the group. The Board regularly reviews the capital structure. No changes were made to the group's objectives and processes during 2011 and 2010.

The general funding policy is to raise and invest funds centrally to meet anticipated requirements using a combination of capital market bond issuance, commercial paper borrowing, committed borrowing facilities and investments. These financial instruments vary in their maturity in order to meet short, medium and long-term requirements.

At 31 March 2011 the group had financial assets of £3.7bn (2010: £6.5bn) consisting of current and non-current investments, derivative financial assets, trade and other receivables, cash and cash equivalents. The reduction in 2011 principally reflects the use of cash and investments to fund £2.5bn of debt maturities.

Credit exposures are continually reviewed and proactive steps are taken to ensure that the impact of adverse market conditions on these financial assets is minimised. In particular, line of business management actively review exposures arising from trading balances and, in managing investments and derivative financial instruments, the treasury operation monitors the credit quality across treasury counterparties and is actively managing exposures which

arise.

Additional disclosures relating to financial assets and financial liabilities are included in notes 15, 16, 19, 20, 21, 22, 25 and 29 to the consolidated financial statements and include a debt maturity profile, currency and interest rate composition and hedging strategy. Details of the group's treasury management policies are included in note 29 to the consolidated financial statements.

Net debt

At 31 March 2011 net debt was £8,816m compared with £9,283m at 31 March 2010, a reduction of £467m. Apart from funding the dividend payments of £543m and pension deficit payments of £1,030m the free cash flow generated from business activities has been used to reduce net debt.

52

FINANCIAL REVIEW FUNDING AND CAPITAL MANAGEMENT

The movement in the group's net debt position in 2011 was as follows:

Movements in net debt

£m	At		Foreign exchange and fair value movements		At 31 March 2011
	1 April 2010	Cash flow		Other movements	
Bank overdrafts	8	18			26
Debt due within 1 year	3,261	(2,331)	(491)	20	459
Debt due after 1 year	9,522	340	(511)	20	9,371
Cash at bank and in hand	(197)	53	3		(141)
Cash equivalents	(1,255)	1,045			(210)
Current asset investments	(406)	365	33	(11)	(19)
	10,933	(510)	(966)	29	9,486
Adjustments ^a	(1,650)		980		(670)
Net debt	9,283	(510)	14	29	8,816

^a Adjustments to net debt of £670m at 31 March 2011 (2010: £1,650m) comprise £408m (2010: £1,326m) arising from the re-translation of currency denominated balances at swapped rates where hedged and £262m (2010: £324m) to remove fair value adjustments and accrued interest.

The group had two significant term debt maturities during 2011 totalling £2.5bn. In December 2010 an 8.125% (9.37% including step-up coupons) US Dollar bond matured with a principal of \$2,883m (£1,742m after including associated currency swaps) and in February 2011 a 6.875% (7.87% including step-up coupons) Euro bond matured with a principal of 1,125m (£758m after including associated currency swaps). The £2.5bn of maturing debt was funded from surplus cash and investments held in anticipation of this requirement. The group has no significant debt

maturities until 2013. The maturity profile of the group's term debt is shown in the table below.

Borrowing facilities

In March 2011 the group extended and reduced the level of committed facilities to provide cost efficient medium-term funding security with a five-year £1.5bn committed facility. This facility replaced the £1.5bn facility maturing in January 2013 and the £650m facility maturing in May 2012.

Pensions

Funding valuation and future funding obligations

The funding of the group's main defined benefit pension plan, the BTPS, is subject to a legal agreement between BT and the Trustee determined at the conclusion of each triennial funding valuation. The most recent triennial funding valuation at 31 December 2008 and associated recovery plan was agreed with the Trustee in February 2010.

Under this prudent funding valuation basis, at 31 December 2008 the assets of the BTPS had a market value of £31.2bn and a funding deficit of £9.0bn. If the valuation had used a median estimate approach, we estimate that the deficit would have been about £3bn at December 2008. This approach reflects how investments might on average be expected to perform over time and the expected impact of the pensions review changes implemented on 1 April 2009. Since the valuation date the scheme's assets have increased by £5.8bn and the liabilities have reduced as a result of the UK Government's announcement regarding future indexation of pension benefits. The Trustee's initial estimate is that if the funding valuation was performed at 31 December 2010, the deficit would have been around £3.2bn on this prudent valuation basis, after the deficit payments of £1,030m in 2011. On a median estimate basis, we estimate that there is a surplus of £3.2bn at 31 March 2011. The next funding valuation is due to be carried out as at 31 December 2011.

Following the agreement of the valuation, the ordinary contributions rate reduced from 19.5% to 13.6% reflecting the changes to member benefits implemented with effect from 1 April 2009. In addition, the group agreed to make deficit payments of £525m per annum for the first three years of a 17-year recovery plan, the first two of which were made in December 2009 and 2010. In March 2011, the group paid £505m representing the actuarial value of the £525m payment due to have been made in December 2011. The payment in December 2012 will be £583m, then increasing at 3% per annum. The payments in years four to 17 are equivalent to £533m per annum in real terms, assuming annual inflation of 3%.

The Pensions Regulator's review of the 2008 BTPS funding valuation and recovery plan is now on hold and is not expected to recommence until the outcome of final Court decision, including any potential appeals, is known on the Crown Guarantee. We do not expect this to be before the completion of the next triennial funding valuation as at 31 December 2011. As is usual, BT and the Trustee will engage with the Pensions Regulator regarding 2011 valuation. The BTPS was closed to new entrants on 31 March 2001 and people joining BT after that date can participate in a defined contribution pension arrangement. Total membership of the BTPS at 31 March 2011 was 327,500. The number of retired members has been increasing in recent years. Consequently, our future pension costs and contributions will principally depend on the investment returns, mortality of members and inflation, all of which could fluctuate in the medium to long-term.

^a Balances
reported at
swapped rates
where hedged.

FINANCIAL REVIEW FUNDING AND CAPITAL MANAGEMENT/FINANCIAL POSITION AND RESOURCES

Further details of the BTPS, funding arrangements, triennial valuation and the IAS 19 accounting valuations are provided in note 23 to the consolidated financial statements together with the key demographic and financial assumptions used in the valuations.

Contractual obligations and commitments

A summary of the group's principal contractual financial obligations and commitments at 31 March 2011 is shown below. Further details on the items can be found in the notes to the consolidated financial statements. Details of the group's capital commitments and contingent liabilities are included in note 30 to the consolidated financial statements. At 31 March 2011 the group had cash, cash equivalents and current asset investments of £370m. The group also had an unused committed borrowing facility amounting to £1.5bn. These resources allow the group to settle its obligations as they fall due.

Contractual obligations and commitments

£m	Total	Payments due by period			
		Less than 1 year	Between 1 and 3 years	Between 3 and 5 years	More than 5 years
Loans and other borrowings ^a	9,565	483 ^b	1,722	2,087	5,273
Finance lease obligations	294	2	35	22	235
Operating lease obligations	7,192	464	853	756	5,119
Capital commitments	467	455	10	1	1
Pension deficit obligations	9,962		1,183	1,256	7,523
Total	27,480	1,404	3,803	4,122	18,151

^aExcludes fair value adjustments for hedged risks.

^bIncludes £266m of accrued interest within less than one year.

Off-balance sheet arrangements

As disclosed in the consolidated financial statements, there are no off-balance sheet arrangements that have or are reasonably likely to have a current or future material effect on the group's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditure or capital resources, with the exception of financial commitments and contingent liabilities disclosed in note 30 to the consolidated financial statements.

Quantitative and qualitative disclosures about interest, foreign exchange, credit and liquidity risks

A discussion of the group's financial risk management objectives and policies and the exposure of the group to interest rate, foreign exchange, credit and liquidity risk is included in note 29 to the consolidated financial statements.

Going concern

The **Business review** on pages 8 to 43 includes information on the group structure, the performance of each of the lines of business, the impact of regulation and competition and principal risks and uncertainties. This **Financial review** includes information on our financial results, financial outlook, liquidity, funding and capital management and our financial position and resources. Notes 15, 16, 20, 21 and 29 of the consolidated financial statements include information on the group's investments, cash and cash equivalents, borrowings, derivatives, financial risk management objectives, hedging policies and exposures to interest, foreign exchange, credit, liquidity and market risks.

Alongside the factors noted above, the directors have considered the group's cash flow forecasts, in particular with reference to the period to the end of May 2012. The directors are satisfied that this cash flow forecast, taking into account reasonably possible risk sensitivities associated with this forecast and the group's current funding and facilities, alongside the group's funding strategy, shows that the group will continue to operate for the foreseeable future. The directors therefore continue to have a reasonable expectation that the group has adequate resources to continue in operational existence for the foreseeable future and continue to adopt a going concern basis (in accordance with the guidance 'Going Concern and Liquidity Risk: Guidance for Directors of UK Companies 2009' issued by the Financial Reporting Council) in preparing the consolidated financial statements.

There has been no significant change in the financial or trading position of the group since 31 March 2011.

FINANCIAL POSITION AND RESOURCES

Summarised balance sheet

	2011	2010
	£m	£m
Non-current assets		
Goodwill & acquisition related intangible assets	1,566	1,720
Property, plant and equipment & software	16,446	16,808
Deferred tax asset	461	2,196
Trade and other receivables	286	336
Other non-current assets	850	1,335
	19,609	22,395
Current assets		
Cash and cash equivalents	351	1,452
Trade and other receivables	3,332	3,696
Other current assets	248	1,137
	3,931	6,285
Current liabilities		
Trade and other payables	6,114	6,531
Loans and other borrowings	485	3,269
Other current liabilities	432	620
	7,031	10,420
Non-current liabilities		
Loans and other borrowings	9,371	9,522
Provisions	807	707
Deferred tax liability	1,212	1,456
Retirement benefit obligations	1,830	7,864
Other non-current liabilities	1,338	1,337

	14,558	20,886
Total equity (deficit)	1,951	(2,626)

Balance sheet items

Goodwill and acquisition related intangible assets

Goodwill decreased by £75m during 2011 to £1,357m. This reduction primarily reflected an impairment of £39m and the impact of foreign exchange movements. Acquired intangible assets decreased by £79m during 2011 to £209m, principally due to amortisation of £61m, impairments of £10m and the impact of foreign exchange movements.

54

FINANCIAL REVIEW FINANCIAL POSITION AND RESOURCES**Property, plant and equipment and software**

Property, plant and equipment and internally developed and purchased software decreased by £362m to £16,446m at 31 March 2011, principally due to capital expenditure of £2,590m, (further details of which are given below) which was more than offset by £2,979m of depreciation and amortisation.

Capital expenditure

Capital expenditure, on an accruals basis, totalled £2,590m in 2011 (2010: £2,533m; 2009: £3,088m), in line with our expectations of around £2.6bn.

The capital expenditure by major area over the last three years is shown below.

In 2011 platforms and networks expenditure was £1,145m (2010: £1,135m). A significant element of the platform expenditure was on our super-fast fibre-based broadband services network. To date, we have spent £0.6bn of our £2.5bn potential investment in our fibre roll-out programme. This expenditure is being managed within our capital expenditure plans. Access expenditure was £591m (2010: £566m) for connecting our customers to the network.

Customer related expenditure was £599m (2010: £560m), principally relating to major customer contracts in BT Wholesale and BT Global Services. This also included product development, testing and fault reduction investments across the group.

Of the capital expenditure, £227m (2010: £280m) arose outside of the UK. Contracts placed for ongoing capital expenditure totalled £467m at 31 March 2011 (2010: £383m).

Capital expenditure for the last five financial years is included in the **Financial statistics** section on page 160.

Deferred tax

The deferred tax asset of £461m (2010: £2,196m) relates to the group's retirement benefit obligations, as detailed in note 23 to the consolidated financial statements. The deferred tax liability decreased by £244m to £1,212m at 31 March 2011, mainly reflecting the 2% reduction in the rate of UK corporation tax, effective 1 April 2011. Movements in deferred tax assets and liabilities are disclosed in note 24 to the consolidated financial statements.

Cash and cash equivalents

For further details on cash and cash equivalents refer to **Liquidity** and **Funding and capital management** on pages 50 and 52 respectively.

Trade and other receivables

Current trade and other receivables decreased by £364m to £3,332m at 31 March 2011 principally reflecting improvements to working capital in BT Global Services.

Trade and other payables

Trade and other payables decreased by £417m to £6,114m at 31 March 2011 principally reflecting the impact of the reduction in our cost base in 2011.

Loans and other borrowings

For further details of movements in our loans and other borrowings, see **Net debt** on page 52.

Provisions

Current and non-current provisions increased by £115m to £956m at 31 March 2011. The movements in provisions are disclosed in note 25 to the consolidated financial statements.

Retirement benefit obligations

A summary of movements in the IAS 19 accounting deficit is set out below:

	2011	2010
	£bn	£bn
Deficit		
At 1 April	(7.9)	(4.0)
Current service cost	(0.3)	(0.2)
Interest	(0.1)	(0.3)
Actuarial gain (loss)	5.2	(4.3)

Contributions	1.3	0.9
At 31 March	(1.8)	(7.9)
Deferred tax asset	0.4	2.2
Net of deferred tax at 31 March	(1.4)	(5.7)

The market value of the BTPS assets have increased by £1.7bn since 31 March 2010 to £37.0bn at 31 March 2011 principally reflecting the continuation of strong asset performance with a 7% return and deficiency contributions of £1.0bn offsetting benefits paid of £2.0bn. At 31 March 2011 the value of the BTPS liabilities have decreased by £4.3bn to £38.7bn principally as a result of the £3.5bn impact of the UK Government decision that the Consumer Prices Index (CPI), rather than the Retail Prices Index (RPI), will be used for revaluation and indexation of occupational pension rights. The present value of the liabilities continues to reflect the low real yield on bonds over the last two years. Further details and detailed pensions accounting disclosures are provided in note 23 to the consolidated financial statements.

Equity

A summary of the movements in equity is set out below:

	2011 £m	2010 £m
(Deficit) equity at 1 April	(2,626)	169
Profit for the year	1,504	1,029
Other comprehensive income (loss)	3,449	(3,661)
Dividends to shareholders	(543)	(263)
Share-based payment	68	81
Tax on share-based payment	91	19
Net issue of treasury shares	8	4
Movements in non-controlling interests		(4)
Equity (deficit) at 31 March	1,951	(2,626)

The increase in equity in 2011 is principally due to the profit for the year and the recognition of actuarial gains on retirement benefit obligations.

BT Group plc, the parent company, had a profit and loss reserve, net of the treasury reserve, of £9,198m at 31 March 2011. The financial statements of BT Group plc are prepared in accordance with UK GAAP.

FINANCIAL REVIEW FINANCIAL POSITION AND RESOURCES/ALTERNATIVE PERFORMANCE MEASURES

Other comprehensive income

Included in other comprehensive income for 2011 of £3,449m (2010: £3,661m other comprehensive loss) are actuarial gains of £5,109m (2010: £4,324m loss), foreign exchange losses on the translation of overseas operations of £140m (2010: £119m loss), net fair value losses on cash flow hedges of £14m (2010: £575m) and a tax charge of £1,521m (2010: £1,350m credit) relating to items recognised in other comprehensive income.

Treasury shares

At 31 March 2011 the company held 389m shares (2010: 401m) in Treasury. These shares are used to settle exercises of share options and share awards. The carrying value of £1,078m (2010: £1,105m) has been deducted from retained earnings.

Acquisitions and disposals

We actively review our portfolio of assets and acquisition opportunities in our target markets. We will consider acquiring companies if they bring us skills, technology, geographic reach or time-to-market advantage for new products and services.

During 2011 there were no acquisitions. However, we completed the following equity investments:

Date	Investment
May 2010	A 2.6% shareholding in OnLive Inc., a Silicon Valley based, cloud computing video gaming business. BT has exclusive rights to bundle the OnLive® Game Service with broadband in the UK.
September 2010	A 14.3% shareholding in YouView TV Limited, a joint venture between the BBC, ITV, BT, Channel 4 and others to bring a new free-to-air internet-connected TV service to UK homes.

Also during 2011 we completed the following disposal:

Date	Disposal
December 2010 and March 2011	A 6.5% interest in our associate Tech Mahindra was sold for total consideration of £74m.

We also completed a number of other minor disposals in 2011.

Legal proceedings

We do not believe that there is any single current court action that would have a material adverse effect on the financial position or operations of the group. During 2011 the aggregate volume and value of legal actions to which the group is party remained broadly the same as at the end of 2010, during which the levels had increased significantly.

Principal accounting policies, critical accounting estimates and key judgements

Our principal accounting policies are set out on pages 91 to 99 of the consolidated financial statements and conform with IFRS. These policies, and applicable estimation techniques, have been reviewed by the directors who have confirmed them to be appropriate for the preparation of the 2011 consolidated financial statements.

We, in common with virtually all other companies, use estimates in the preparation of our consolidated financial statements. Details of critical accounting estimates and key judgements are provided in the accounting policies on

pages 97 and 98.

ALTERNATIVE PERFORMANCE MEASURES

Introduction

We assess the performance of the group using a variety of alternative performance measures. We principally discuss the group's results on an adjusted basis. The rationale for using adjusted measures is explained below. Results on an adjusted basis are presented before specific items.

We also explain financial performance using measures that are not defined under IFRS and are therefore termed non-GAAP measures. The non-GAAP measures we use are reported and adjusted EBITDA, reported and adjusted free cash flow and net debt. A reconciliation from these non-GAAP measures to the nearest measure prepared in accordance with IFRS is presented below. The alternative performance measures we use may not be directly comparable to similarly titled measures used by other companies.

Specific items

Definition

The group's income statement and segmental analysis separately identify trading results before specific items. Specific items are those that in management's judgment need to be disclosed by virtue of their size, nature or incidence. In determining whether an event or transaction is specific, management considers quantitative as well as qualitative factors such as the frequency or predictability of occurrence. This is consistent with the way that financial performance is measured by management and reported to the Board and the *Operating Committee* and assists in providing a meaningful analysis of the trading results of the group. The directors believe that presentation of the group's results in this way is relevant to an understanding of the group's financial performance as specific items are identified by virtue of their size, nature or incidence.

Items which have been considered to be specific items by virtue of their size, nature or incidence include disposals of businesses and investments, business restructuring programmes, asset impairment charges, property rationalisation programmes and the settlement of multiple tax years in a single payment. In 2011 net interest on pensions has been included in specific items because of its volatile nature, and also BT Global Services contract and financial review charges in 2009, by virtue of their size and nature. Accordingly, specific items for comparative periods have been re-presented to reflect this reclassification.

Specific items in 2011, 2010 and 2009

Specific items recognised in all years are summarised below and disclosed in note 8 to the consolidated financial statements.

Revenue and other operating income

In 2010 a charge of £52m was recognised as a reduction in revenue, reflecting an Ofcom determination in relation to 2Mbps partial private circuits. In 2009 the group recognised BT Global Services contract and financial review charges, of which £41m was recognised as a reduction in revenue.

In 2009 a £13m loss on disposal arose from exiting a business and was recognised as a reduction in other operating income.

FINANCIAL REVIEW ALTERNATIVE PERFORMANCE MEASURES

Operating costs

Specific operating costs of £329m (2010: £427m; 2009: £1,993m) comprised:

BT Global Services restructuring charges of £192m (2010: £301m; 2009: £280m). This included people and property charges of £129m (2010: 132m; 2009: £51m) principally comprising leaver costs and property exit costs and networks, products and procurement channels rationalisation charges of £41m (2010: £142m; 2009: £183m) from rationalising legacy networks, including the associated systems and processes. In 2010, the charge of £142m included a payment of £127m made to Tech Mahindra for the renegotiation of certain supply contracts as part of the rationalisation of procurement channels. In addition intangible asset impairments and other charges of £22m were recognised (2010: £27m; 2009: £46m). Further BT Global Services restructuring charges of around £50m are expected to be incurred in 2012 principally in relation to the network rationalisation programme.

Property rationalisation charges of £88m (2010: £121m; 2009: £nil) in relation to the rationalisation of the group's UK property portfolio.

Intangible assets impairment charges of £49m (2010 and 2009: £nil) relating to goodwill and brands.

BT Global Services contract and financial review charges of £1,598m were recognised in 2009.

A charge of £65m in respect of the group's transformation and reorganisation activities was recognised in 2009.

A £50m charge was recognised in 2009 comprising £31m of asset impairments and £19m of associated costs, following the group's review of its 21CN programme and associated voice strategy.

Net finance expense

Net finance expense on pensions was £79m (2010: £279m expense; 2009: £313m income).

Associates and joint ventures

In 2011 a profit of £42m arose on the disposal of a 6.5% interest in our associate Tech Mahindra. In 2010 a loss on disposal of £12m arose on the disposal of an indirect interest in Tech Mahindra. In 2010 the group also recognised a credit of £29m in connection with the £127m payment to its associate Tech Mahindra, as described above. In 2009 a credit of £36m was recognised in respect of a reassessment of the value of the group's share of the net assets of an associated undertaking.

Taxation

The specific tax credit of £239m in 2011 (2010: £420m; 2009: £414m) comprised:

Tax credit of £72m (2010: £190m; 2009: £414m) on the specific items detailed above.

Tax credit of £172m (2010 and 2009: £nil) for the re-measurement of deferred tax balances as a result of the change in the UK statutory corporation tax rate from 28% to 26% effective in 2012.

In 2010 the group agreed substantially all outstanding tax matters with HMRC relating to the 2008, 2007 and 2006 tax years resulting in a tax repayment. Specific items in 2010 included a tax credit of £230m, associated interest of £11m on the repayment and operating costs of £5m representing costs associated with the settlement.

EBITDA

In addition to measuring financial performance of the lines of business based on operating profit, we also measure performance based on EBITDA and adjusted EBITDA. EBITDA is defined as the group profit or loss before depreciation, amortisation, net finance expense and taxation. Adjusted EBITDA is defined as EBITDA before specific items. EBITDA is a common measure used by investors and analysts to evaluate the operating financial performance of companies, particularly in the telecommunications sector.

We consider EBITDA and adjusted EBITDA to be useful measures of our operating performance because they reflect the underlying operating cash costs, by eliminating depreciation and amortisation. EBITDA and adjusted EBITDA are

not direct measures of our liquidity, which is shown by our cash flow statement, and need to be considered in the context of our financial commitments.

A reconciliation from group operating profit, the most directly comparable IFRS measure, to reported and adjusted group EBITDA, is set out below. A reconciliation between operating profit and adjusted EBITDA for our lines of business is set out in **Segment information**, note 1 to the consolidated financial statements on page 106.

	2011	2010	2009
	£m	£m	£m
Operating profit	2,578	2,123	301
Depreciation and amortisation	2,979	3,039	2,890
Reported EBITDA	5,557	5,162	3,191
Specific items	329	477	2,047
Adjusted EBITDA	5,886	5,639	5,238

Adjusted earnings per share

We also measure financial performance based on adjusted earnings per share, which excludes specific items. Basic and adjusted earnings per share, and the per share impact of specific items, is as follows:

	Pence per share	£m
Year ended 31 March 2011		
Basic earnings per share/profit^a	19.4	1,502
Specific items	1.6	127
Adjusted basic earnings per share/profit	21.0	1,629
Year ended 31 March 2010		
Basic earnings per share/profit^a	13.3	1,028
Specific items ^b	4.0	308
Adjusted basic earnings per share/profit^b	17.3	1,336
Year ended 31 March 2009 ^b		
Basic loss per share/(loss)^a	(2.5)	(193)
Specific items ^b	16.6	1,284
Adjusted basic earnings per share/profit^b	14.1	1,091

^aThe stated profit (loss) amounts are the component of the total profit (loss) which is attributable to equity shareholders excluding non-controlling interests.

^bRe-presented see page 56.

FINANCIAL REVIEW ALTERNATIVE PERFORMANCE MEASURES**Free cash flow**

Reported free cash flow

Reported free cash flow is one of the group's key performance indicators by which our financial performance is measured. Reported free cash flow is defined as the net increase in cash and cash equivalents less cash flows from financing activities (except net interest paid) and less the acquisition or disposal of group undertakings and less the net sale of short-term investments and excluding pension deficit payments. Reported free cash flow is primarily a liquidity measure, however we also believe it is an important indicator of our overall operational performance as it reflects the cash we generate from operations after capital expenditure and financing costs, both of which are significant ongoing cash outflows associated with investing in our infrastructure and financing our operations. In addition, reported free cash flow excludes cash flows that are determined at a corporate level independently of ongoing trading operations such as dividends, share buy backs, acquisitions and disposals and repayment of debt. Our use of the term reported free cash flow does not mean that this is a measure of the funds that are available for distribution to shareholders.

Adjusted free cash flow

We also measure financial performance based on an adjusted basis before specific items. Adjusted free cash flow is before the cash impact of specific items including tax related specific items. For non-tax related specific items, the adjustment is made on a pre-tax basis. Adjusted free cash flow provides an additional measure of the free cash flow generated by the group based on its trading performance.

A reconciliation from net cash inflow from operating activities, the most directly comparable IFRS measure, to reported and adjusted free cash flow is set out below.

	2011	2010	2009
Year ended 31 March	£m	£m	£m
Net cash inflow from operations	4,566	4,825	4,706
Add back pension deficit payment	1,030	525	
Included in cash flows from investing activities			
Net capital expenditure	(2,630)	(2,480)	(3,038)
Interest received	29	16	19
Dividends received from associates	7	3	6
Purchase of non-current financial assets	(18)		
Included in cash flows from financing activities			
Interest paid	(973)	(956)	(956)
Reported free cash flow	2,011	1,933	737
Net cash outflow from specific items	212	173	35
Adjusted free cash flow	2,223	2,106	772

The net cash outflow from specific items of £212m in 2011 principally comprised BT Global Services restructuring charges and property rationalisation costs. The net cash outflow of £173m in 2010 principally comprised BT Global Services restructuring charges and property rationalisation costs, offset by a cash receipt of £226m following the agreement of substantially all outstanding tax matters with HMRC relating to the 2008, 2007 and 2006 tax years. The net cash outflow of £35m in 2009 principally comprised BT Global Services restructuring costs and group transformation costs.

Net debt

Net debt consists of loans and other borrowings (both current and non-current), less current asset investments and cash and cash equivalents. Loans and other borrowings are measured at the net proceeds raised, adjusted to amortise any discount over the term of the debt. For the purpose of this measure, current asset investments and cash and cash equivalents are measured at the lower of cost and net realisable value. Currency denominated balances within net debt are translated to Sterling at swapped rates where hedged.

This definition of net debt measures balances at the expected value of future undiscounted cash flows due to arise on maturity of financial instruments and removes the balance sheet adjustments made from the re-measurement of hedged risks under fair value hedges and the use of the effective interest method. In addition, the gross balances are adjusted to take account of netting arrangements.

Net debt is a measure of the group's net indebtedness that provides an indicator of the overall balance sheet strength. It is also a single measure that can be used to assess both the group's cash position and indebtedness. There are material limitations in the use of alternative performance measures and the use of the term net debt does not necessarily mean that the cash included in the net debt calculation is available to settle the liabilities included in this measure.

Net debt is considered to be an alternative performance measure as it is not defined in IFRS. The most directly comparable IFRS measure is the aggregate of loans and other borrowings (current and non-current), current asset investments and cash and cash equivalents. A reconciliation from this measure, the most directly comparable IFRS measure, to net debt is given below.

At 31 March	2011 £m	2010 £m
Loans and other borrowings	9,856	12,791
Less:		
Cash and cash equivalents	(351)	(1,452)
Current asset investments	(19)	(406)
	9,486	10,933
Adjustments:		
To retranslate currency denominated balances at swapped rates where hedged	(408)	(1,326)
To remove fair value adjustments and accrued interest applied to reflect the effective interest method	(262)	(324)
Net debt	8,816	9,283

BOARD OF DIRECTORS AND OPERATING COMMITTEE

Chairman
Executive directors
Company Secretary
Operating Committee
Non-executive directors

THE BOARD

Corporate governance statement
Directors
Governance and role of the Board
Directors powers to authorise conflicts of interest
BT's non-executive directors
Main Board committees
New York Stock Exchange

REPORT OF THE AUDIT & RISK COMMITTEE

Introduction
Committee role
Committee activities

REPORT OF THE NOMINATING & GOVERNANCE COMMITTEE

Introduction
Committee role
Committee activities
Board evaluation

REPORT OF THE COMMITTEE FOR SUSTAINABLE & RESPONSIBLE BUSINESS

Introduction
Committee role
Committee activities

REPORT ON DIRECTORS REMUNERATION

Overview

Introduction

Remuneration policy (not audited)

Remuneration review (audited)

DIRECTORS INFORMATION

Election and re-election

Meetings attendance

Service agreements

Training and information

Independent advice

Directors and officers liability insurance and indemnity

Interest of management in certain transactions

BUSINESS POLICIES

Responsible business

Political donations

Pension funds

Financial statements

Takeover Directive disclosure

Financial instruments

Internal control and risk management

US Sarbanes-Oxley Act of 2002

Disclosure controls and procedures

Internal control over financial reporting

SHAREHOLDERS AND ANNUAL GENERAL MEETING

Relations with shareholders

Substantial shareholdings

AGM resolutions

Authority to purchase shares

**REPORT OF THE DIRECTORS
BOARD OF DIRECTORS AND OPERATING COMMITTEE**

Chairman

Sir Michael Rake

Chairman ^{d,e,f}

Sir Michael was appointed to the Board as Chairman on 26 September 2007. He also chairs the *Nominating & Governance Committee* and the *Committee for Sustainable & Responsible Business* and is a member of the *Pension Scheme Performance Review Group*. He was formerly chairman of KPMG International from 2002 to 2007, and previously held other roles in KPMG from 1972.

He is chairman of easyJet, a non-executive director of Barclays, where he chairs the audit committee, McGraw Hill and the Financial Reporting Council. Sir Michael's other appointments include vice-president of the RNIB, membership of the board of the TransAtlantic Business Dialogue, the CBI International Advisory Board and the National Security Forum. A Chartered Accountant, he was knighted in 2007 for his services to the accountancy profession. Aged 63.

Executive directors

Ian Livingston

Chief Executive ^{a,f}

Ian Livingston was appointed as Chief Executive on 1 June 2008. He chairs the *Operating Committee* and is a member of the *Pension Scheme Performance Review Group*. He was formerly Chief Executive of BT Retail from 7 February 2005 and Group Finance Director from April 2002. Before joining BT, he was group finance director of Dixons Group from 1997. He joined Dixons in 1991 after working for 3i Group and Bank of America International. His experience at Dixons spanned a number of operational and financial roles, both in the UK and overseas. He is a non-executive director of Celtic and chairman of the audit committee. He is a Chartered Accountant. Aged 46.

Tony Chanmugam

Group Finance Director^a

Tony Chanmugam was appointed to the Board on 1 December 2008 as Group Finance Director and is a member of the *Operating Committee*. He was formerly Chief Financial Officer of BT Retail and Managing Director of BT Enterprises and, from 1997 to 2004, he was Chief Financial Officer and then Chief Operating Officer of BT Global Solutions. Tony was appointed a non-executive director and chairman of the audit committee of Barnet and Chase Farm Hospital Trust in April 2010. He is a Chartered Management Accountant. Aged 57.

Gavin Patterson

Chief Executive, BT Retail ^{a,e}

Gavin Patterson was appointed to the Board on 1 June 2008 as Chief Executive BT Retail and is a member of the *Operating Committee*. He is also a member of the *Committee for Sustainable & Responsible Business*. He was formerly Managing Director, Consumer Division, BT Retail. He is a non-executive director of British Airways. Before joining BT, he was managing director of the consumer division of Telewest. Aged 43.

Company Secretary

Andrew Parker

Andrew Parker, formerly General Counsel, BT Retail from 2004, was appointed Company Secretary on 1 April 2008. A solicitor, he has worked for BT since 1988 in a number of legal, regulatory and compliance roles. He is an employer-nominated trustee director of the BT Pension Scheme. Andrew previously worked in the City in legal private practice. Aged 51.

Operating Committee

Ian Livingston, Chief Executive

Tony Channugam, Group Finance Director

Sally Davis, Chief Executive, BT Wholesale

Jeff Kelly, Chief Executive, BT Global Services

Roel Louwhoff, Chief Executive, BT Operate

Gavin Patterson, Chief Executive, BT Retail

Clive Selley, Chief Executive, BT Innovate & Design

Key to membership of Board committees:

^a Operating

^b Audit & Risk

^c Remuneration

^d Nominating & Governance

^e Sustainable & Responsible Business

^f Pension Scheme Performance Review Group

^g Equality of Access Board

REPORT OF THE DIRECTORS BOARD OF DIRECTORS AND OPERATING COMMITTEE

Non-executive directors

Tony Ball ^{c,d}

Tony Ball was appointed to the Board on 16 July 2009. He is a member of the *Remuneration* and the *Nominating & Governance Committees*. He has held senior executive positions in broadcasting and telecommunications businesses in the UK, US and continental Europe. From 1999 to 2003 he was chief executive of BSkyB. He is chairman of the supervisory board of Kabel Deutschland. He is also a board member of the Olympic Delivery Authority London 2012 and a non-executive director of the Spanish cable company ONO. Aged 55.

Clayton Brendish ^{b,d,e}

Clay Brendish was appointed to the Board on 1 September 2002. He is a member of the *Audit & Risk* and the *Nominating & Governance Committees*, and the *Committee for Sustainable & Responsible Business*. He is non-executive chairman of Anite, SThree, and Echo Research and non-executive director of Herald Investment Trust. He is also a trustee of Economist Newspapers. Prior to his retirement in 2001, Clay was executive deputy chairman of CMG having joined the board when it acquired Admiral. Clay was co-founder and executive chairman of Admiral. He also acted as an adviser to the Government on the efficiency of the Civil Service. Aged 64.

J Eric Daniels ^{c,d}

Eric Daniels was appointed to the Board on 1 April 2008. He is a member of the *Remuneration* and the *Nominating & Governance Committees*. He was group chief executive of Lloyds Banking Group (formerly Lloyds TSB Group) until March 2011 having been a director since 2001. Immediately prior to joining Lloyds TSB Group, he was chairman and chief executive of Zona Financiera. Eric worked for Citibank from 1975 to 2000, becoming chief operating officer of Citibank's consumer bank, then chairman and chief executive of Travelers Life and Annuity following its merger with Citibank. Aged 59.

Rt Hon Patricia Hewitt ^{b,c,d,f}

Patricia Hewitt was appointed to the Board on 24 March 2008 and became Senior Independent Director in July 2009. She chairs the *Remuneration Committee* and the *Pension Scheme Performance Review Group* and is a member of the *Audit & Risk* and the *Nominating & Governance Committees*. Patricia stepped down as an MP at the 2010 election. She joined Groupe Eurotunnel SA as an independent non-executive director in May 2010. She was Secretary of State for Health from 2005 to 2007 and previously Trade and Industry and Cabinet Minister for Women from 2001 to 2005. Before entering Parliament in 1997, she was director of research EMEA at Andersen Consulting (now Accenture) and deputy director of the Institute for Public Policy Research. A British and Australian dual national, she is aged 62.

Phil Hodkinson ^{b,d,e,f}

Phil Hodkinson was appointed to the Board on 1 February 2006. He is chairman of the *Audit & Risk Committee* and is a member of the *Nominating & Governance Committee*, the *Committee for Sustainable & Responsible Business*, and the *Pension Scheme Performance Review Group*. He is a non-executive director of HM Revenue & Customs, Travelex, Resolution and Business in the Community, and a trustee of Christian Aid and BBC Children in Need. Prior to his retirement in 2007, Phil's roles included group finance director of HBOS, chairman of Insight Investment and Clerical Medical, and chief executive of Zurich Life and Eagle Star Life. He is a Fellow of the Institute of Actuaries. Aged 53.

Nicholas Rose ^b

Nick Rose was appointed to the Board on 1 January 2011 and is a member of the *Audit & Risk Committee*. He has been a non-executive director of BAE Systems since February 2010 and retired as group finance director of Diageo in October 2010, having been on the board since joining in 1999. Prior to Diageo, Nick was a member of the board of GrandMet and in his early career spent 11 years with Ford Finance in a number of different roles. Nick was appointed chairman of Edwards Vacuum on 24 March 2011. Aged 53.

Carl G Symon ^{b,c,g}

Carl Symon was appointed to the Board on 14 January 2002, and appointed chairman of the *Equality of Access Board* when it became operational on 1 November 2005. He is a member of the *Audit & Risk* and the *Remuneration Committees*. He retired from IBM in May 2001 after a 32-year career, during which he held senior executive positions

in the US, Canada, Latin America, Asia and Europe. Carl is a non-executive director of BAE Systems and Rexam. He was formerly chairman of the HMV Group and a non-executive director of Rolls-Royce. A US national, he is aged 65.

Jasmine Whitbread^e

Jasmine Whitbread was appointed to the Board on 19 January 2011 and is a member of the *Committee for Sustainable & Responsible Business*. She was appointed chief executive of Save the Children International in 2010, having joined Save the Children in 2005. Jasmine held positions with Oxfam until 2005 and prior to this served as a managing director of Thomson Financial based in the US. A British and Swiss dual national, she is aged 47.

REPORT OF THE DIRECTORS THE BOARD

Corporate governance statement

Directors

Governance and role of the Board

Directors powers to authorise conflicts of interest

BT's non-executive directors

Main Board committees

New York Stock Exchange

BT Group plc is the listed holding company for the BT group of companies: its shares are listed on the London Stock Exchange and on the New York Stock Exchange in the form of American Depositary Shares.

The BT Board is committed to operating in accordance with best practice in business integrity and ethics, whilst maintaining the highest standards of financial reporting and corporate governance. We believe that good corporate governance should not be a bureaucratic burden but should be clear and straightforward and support the business by providing it with simple guidelines for decision making and risk management.

Key activities

With operations worldwide, the BT governance framework has to reflect diverse cultures and regulatory environments. During the year we reviewed our corporate governance framework.

We have extended the role of the *Audit Committee* to reflect an increased focus on risk. The *Audit & Risk Committee* recommends to the Board the group's risk appetite and reviews its risk profile.

We have extended the remit of the *Nominating Committee* (now the *Nominating & Governance Committee*) to give it the responsibility for oversight of governance and compliance issues.

We also established five regional governance committees to have oversight of BT's group-wide governance policies across their region, particularly focusing on corporate governance and compliance, ethics, business principles, and data retention and protection.

We have commented on many of the various recent consultations on governance, including those leading to the new UK Corporate Governance Code, and the associated Guidance on Board Effectiveness.

The directors submit their report and the audited financial statements of the company, BT Group plc, and the group, which includes its subsidiary undertakings, for the 2011 financial year.

The **Business review** on pages 8 to 43 forms part of this report. The audited financial statements are presented on pages 91 to 150 and 155.

Corporate governance statement

We are committed to operating in accordance with best practice in business integrity and ethics and maintaining the highest standards of financial reporting and corporate governance. The directors consider that BT has, throughout the year, complied with the provisions set out in Section 1 of the 2008 Combined Code on Corporate Governance (the Code) and applied the main principles of the Code as described in pages 60 to 86 of this Report. The Code and associated guidance can be found on the Financial Reporting Council website at

www.frc.org.uk/corporate/combinedcode.cfm

The Code was replaced in May 2010 by the UK Corporate Governance Code (the New Code) for financial years beginning on or after 29 June 2010. It is the intention of the directors to comply with the New Code and during 2011 we have sought to implement its provisions early as appropriate.

Directors

The names and biographical details of the directors are given on pages 60 and 61 in **Board of Directors and Operating Committee**.

Changes to the composition of the Board from 1 April 2010 are set out in the table below:

New directors	Date of appointment
Nick Rose	1 January 2011
Jasmine Whitbread	19 January 2011

Following a nine-year term as a director, Clay Brendish's current appointment will end on 31 August 2011 when he will retire from the Board.

REPORT OF THE DIRECTORS THE BOARD

Governance and role of the Board

The Board, which operates as a single team, is made up of the part-time Chairman, the Chief Executive, two other executive directors and eight non-executive directors. All the non-executive directors during 2011 met, and continue to meet, the criteria for independence set out in the New Code and are therefore considered by the Board to be independent.

Board composition

Carl Symon and Nick Rose are both non-executive directors of BAE Systems plc and the Board has determined that, as they both serve in a non-executive capacity, they are independent for the purposes of paragraph A.3.1. of the Code (paragraph B.1.1 of the New Code).

The Board viewed the Chairman as independent at the time of his appointment. The Board comprised a majority of independent non-executive directors throughout 2011.

The Board is ultimately responsible for the management of the group's operations in addition to discharging certain legal responsibilities. It has final responsibility for the group's strategy and for overseeing the group's performance. Its principal focus is on:

strategy

development

growing shareholder value

oversight and control

corporate governance.

It approves BT's:

values, ethics and business policies and practices

strategic plans

annual budget

capital expenditure and investments budgets

larger capital expenditure proposals

the overall system of internal controls, governance and compliance authorities.

The Board also oversees internal controls, operating and financial performance and reviews the risk register. These responsibilities are set out in a formal statement of the Board's role which is available at www.bt.com/board

The Board has agreed the corporate governance framework, including giving authority to the key management committee, the *Operating Committee*, to make decisions on operational and other matters. The roles and powers of this Committee are set out below.

The Board normally meets nine times each year. The Board met 10 times during the 2011 financial year.

The roles of the Chairman and the Chief Executive are separate. They are set out in written job descriptions, approved by the *Nominating & Governance Committee*. The Chairman provides strong leadership for the Board on all aspects of its role. As well as chairing the Board, the Chairman consults the non-executive directors, particularly the Senior Independent Director, on corporate governance issues, matters considered by the *Nominating & Governance Committee*, which the Chairman chairs, and the individual performance of the non-executive directors. The Chairman,

through the Company Secretary, ensures a full and comprehensive induction is provided to new non-executive directors. The Chairman and the non-executive directors hold regular meetings at which they discuss matters without the executive directors being present. With the Chief Executive and the Company Secretary, the Chairman ensures that the Board is kept properly informed, is consulted on all issues reserved to it and that its decisions are made in a timely and considered way that enables the directors to fulfil their fiduciary duties. The Chairman ensures that the views of the shareholders are known to the Board and considered appropriately. He represents BT in specified strategic and Government relationships, as agreed with the Chief Executive, and generally acts as the bridge between the Board and the executive team, particularly on BT's broad strategic direction. The Chairman's other current significant commitments are shown in **Board of directors and Operating Committee** on page 60. The Chief Executive has final executive responsibility, reporting to the Board, for the success of the group.

The Company Secretary manages the provision of timely, accurate and considered information to the Board for its meetings and, in consultation with the Chairman and Chief Executive, at other appropriate times. He recommends to the Chairman and the Chief Executive, for Board consideration where appropriate, corporate governance policies and practices and is responsible for communicating and implementing them. He advises the Board on appropriate procedures for the management of its meetings and duties (and the meetings of the main committees), as well as corporate governance and compliance within the group. The appointment and removal of the Company Secretary is a matter for the whole Board.

Directors powers to authorise conflicts of interest

All directors have a duty under the Companies Act 2006 (the 2006 Act) to avoid a situation in which he or she has or can have a direct or indirect interest that conflicts or possibly may conflict with the interests of the company. The company's Articles of Association include provisions for dealing with directors' conflicts of interest in accordance with the 2006 Act. The Company has procedures in place, which it follows, to deal with situations where directors may have any such conflicts, which require the Board to:

- consider each conflict situation separately on its particular facts

- consider the conflict situation in conjunction with the rest of their duties under the 2006 Act

- keep records and Board minutes as to authorisations granted by directors and the scope of any approvals given

- regularly review conflict authorisation.

BT's non-executive directors

The *Nominating & Governance Committee* has agreed and reviews from time to time the combination of experience, skills and other attributes which the non-executive directors as a whole should bring to the Board. This profile is used by the Committee, when the appointment of a non-executive director is being considered, to assess the suitability of candidates. Short-listed candidates meet members of the Committee, which then recommends candidates to the Board for appointment. This year, following this process, the Board appointed Nick Rose and Jasmine Whitbread, as new non-executive directors.

REPORT OF THE DIRECTORS THE BOARD

The non-executive directors provide a strong, independent element on the Board and are well placed to constructively challenge and help develop proposals on strategy. Between them, they bring experience and independent judgment, gained at the most senior levels of international business operations and strategy, finance, marketing, technology, communications and political and international affairs and corporate social responsibility. In her capacity as the Senior Independent Director, and as the chair of the *Remuneration Committee*, Patricia Hewitt meets regularly with BT's major institutional shareholders and shareholder representative bodies. She is able, if necessary, to discuss matters with these shareholders where it would be inappropriate for those discussions to take place with either the Chairman or the Chief Executive.

Non-executive directors are appointed initially for three years, subject to three months' termination notice from either BT or the director and automatic termination in the event of not being re-elected by shareholders. Appointments may be extended for usually up to two further three year periods, provided the director remains independent.

Carl Symon completed nine years of service in January 2011 and, in accordance with the New Code, the Board assessed whether Carl is independent of management and any business or other relationship that could materially interfere with the exercise of objective or independent judgment by him or his ability to act in the best interests of the Group. The Board took into account the way he performs the role of chairing the Equality of Access Board (as described in **Main Board committees** below) which it considers evidence of Carl's independence by nature of the role performed. The Board concluded that Carl remains a valuable and effective independent non-executive director and he demonstrates the highest commitment to the role.

Each non-executive director is provided, upon appointment, with a letter setting out the terms of his or her appointment, including membership of Board committees, the fees to be paid and the time commitment expected from the director. The letter also covers such matters as the confidentiality of information and BT's share dealing code.

Main Board committees

The *Operating Committee*, the key management committee, meets weekly and is chaired by the Chief Executive. The other members are the Group Finance Director and the Chief Executives of BT Retail, BT Wholesale, BT Global Services, BT Innovate & Design and BT Operate. The Company Secretary attends all meetings and the Group HR Director normally attends the meetings. The Committee has collective responsibility for running the group's business. To do that, it develops BT's strategy and budget for Board approval, recommends to the Board capital expenditure and investment budgets, monitors financial, operational and customer quality of service performance, reviews the risk register and individual risks on it, allocates resources across BT within plans agreed by the Board, plans and delivers major programmes, and reviews the senior talent base and succession plans. Within BT's corporate governance framework, approved by the Board, the *Operating Committee* can approve, up to limits beyond which Board approval is required, capital expenditure, disposals of fixed assets, investments and divestments. It can, and has, delegated some of these approvals, up to its own limits, to sub-committees and to senior executives.

To meet best corporate governance practice, the *Audit & Risk Committee*, the *Remuneration Committee* and the *Nominating & Governance Committee* have long been an established part of BT's system of governance. Each committee has written terms of reference, which are available on our website. The **Report of the Audit & Risk Committee**, the **Report of the Nominating & Governance Committee** and the **Report on directors' remuneration** are on pages 65 to 81. The **Report of the Committee for Sustainable & Responsible business** is included on page 68. The *Equality of Access Board* (EAB), which is also a committee of the Board, was established, as part of the Undertakings given by BT to Ofcom following Ofcom's strategic review of telecommunications, to monitor, report and advise BT on BT's compliance with these Undertakings. As required by the Undertakings, the EAB comprises five members: Carl Symon, a BT non-executive director and chairman of the EAB; a BT senior executive, Dr Tim Whitley, Group Strategy Director (replacing Himanshu Raja, then Chief Financial Officer, BT Innovate & Design who has stepped down as a member of the committee); and three independent members: Sir Bryan Carsberg, Stephen Pettit and Dr Peter Radley. The EAB reports regularly to the Board. Its terms of reference are available on BT's website. The EAB publishes an annual report to Ofcom, which is also available on BT's website.

The Board also has a *Pension Scheme Performance Review Group*, which reviews the position of the BT Pension Scheme and issues affecting its ongoing funding.

New York Stock Exchange

BT, as a foreign issuer with American Depositary Shares listed on the New York Stock Exchange (NYSE), is obliged to disclose any significant ways in which its corporate governance practices differ from the corporate governance listing standards of the NYSE.

We have reviewed the NYSE's listing standards and believe that our corporate governance practices are consistent with them, with the following exception where we do not meet the strict requirements set out in the standards. These state that companies must have a nominating/corporate governance committee composed entirely of independent directors and with written terms of reference which, in addition to identifying individuals qualified to become board members, develops and recommends to the Board a set of corporate governance principles applicable to the company. During the year we renamed our Nominating Committee the *Nominating & Governance Committee* and extended its terms of reference to include governance and compliance issues (see **Report of the Nominating & Governance Committee** on page 67). The *Nominating & Governance Committee's* terms of reference are in line with the requirements set out in the standards. However, the Committee is chaired by the Chairman, Sir Michael Rake, who is not considered independent under the NYSE's listing standards. The Board and the *Nominating & Governance Committee* are made up of a majority of independent, non-executive directors.

The Sarbanes-Oxley Act of 2002, (Sarbanes-Oxley) the US Securities and Exchange Commission (SEC) and NYSE introduced rules on 31 July 2005 requiring companies to comply with certain provisions relating to their audit committee. These include the independence of audit committee members and procedures for the treatment of complaints regarding accounting or auditing matters. We are fully compliant with these requirements.

REPORT OF THE DIRECTORS REPORT OF THE AUDIT & RISK COMMITTEE

Introduction

During the year the Committee undertook the annual review of its terms of reference. The review focused primarily on extending the Committee's role in relation to assurance and oversight of risk management within the group. Following this review the Committee was re-named the *Audit & Risk Committee* to emphasise its strengthened role in relation to risk.

The *Audit & Risk Committee* is chaired by Phil Hodkinson. The other members are Clay Brendish, Patricia Hewitt, Nick Rose and Carl Symon. They are all independent non-executive directors. With the exception of Nick Rose who joined the Committee on 14 April 2011, they were all members of the Committee throughout the 2011 financial year. The Board considers that the Committee's members have broad commercial knowledge and extensive business leadership experience, having held between them various prior roles in major business, Government, financial management, treasury and financial function supervision and that this constitutes a broad and suitable mix of business and financial experience. The Board has reviewed membership of the Committee and is satisfied that it includes members, Phil Hodkinson and Nick Rose, who have recent and relevant financial experience as required for the provisions of the Code and that they constitute audit committee financial experts for the purposes of the US Sarbanes-Oxley Act. The Committee met six times during the financial year: in April, May, July, September, November and January and the Chairman of the Committee reported on the discussions at the next Board meeting. The Group Finance Director, Company Secretary, Director Internal Audit and Director Group Financial Control although not members of the *Audit & Risk Committee*, attend meetings with the agreement of the Chairman of the Committee. The external auditors normally attend meetings, although they are not present when the Committee discusses their performance and/or remuneration. The Committee members meet regularly with the external and internal auditors without management being present. The papers and minutes of the *Audit & Risk Committee* meetings are also sent to directors who are not members of the Committee.

Committee role

The Committee's terms of reference are available from the Company Secretary and are posted on our website at www.bt.com/committees. The Committee recommends the appointment and reappointment of the external auditors and considers their resignation or dismissal, recommending to the Board appropriate action to appoint new auditors. PricewaterhouseCoopers LLP have been the company's auditors for many years. Having reviewed the independence and effectiveness of the external auditors, the Committee has not considered it necessary to date to require them to tender for the audit. The external auditors are required to rotate the lead partner every five years, and other partners that are responsible for the group and subsidiary audits every seven years. The lead partner currently responsible for BT's audit is completing his second year. The Committee discusses with the auditors the scope of their audits before they commence, reviews the results and considers the formal reports of the auditors and reports the results of those reviews to the Board. The Committee reviews the auditors' performance each year by gathering feedback from Committee members and senior management, and by considering reports on the audit firm's own internal quality control procedures and assessment of independence. No contractual obligations exist that restrict the group's choice of external audit firm.

As a result of regulatory or similar requirements, it may be necessary to employ the external auditors for certain non-audit services. In order to safeguard the independence and objectivity of the external auditors, the Board has determined policies as to what non-audit services can be provided by the external auditors and the approval processes related to them. Under those policies, work of a consultancy nature is not to be offered to the external auditors unless there are clear efficiencies and value-added benefits to the company. The overall policies and processes to implement them were reviewed and appropriately modified in the light of the provisions of the Sarbanes-Oxley Act relating to non-audit services that external auditors may not perform. The *Audit & Risk Committee* monitors the extent of non-audit services being performed by the external auditors and approves any services not included on the list of services the Committee has pre-approved before the work is undertaken. It also monitors the level of non-audit fees paid to the auditors. Details of non-audit services carried out by the external auditors are in note 7 in the **Notes to the consolidated financial statements** on page 114.

The *Audit & Risk Committee* reviews BT's published financial results, the Annual Report & Form 20-F and other published information for statutory and regulatory compliance. It reports its views to the Board to assist it in its approval of the results announcements and the Annual Report & Form 20-F.

The Committee also reviews the disclosures made by the Chief Executive and Group Finance Director during the certification process for the Annual Report about the design and operation of internal controls or weaknesses in the controls, including any fraud involving management or other employees who have a significant role in the company's financial controls. The Board, as required by UK law, takes responsibility for all disclosures in the Annual Report. The *Audit & Risk Committee* reviews internal audit and its relationship with the external auditors, including plans and performance; and monitors, reviews and reports on risk management processes and the standards of risk management and internal control, including the processes and procedures for ensuring that material business risks, including risks relating to IT security, fraud and related matters, are properly identified and managed. Additionally the Committee reviews on behalf of the Board the group's risk profile, endorses a programme of testing of the risk mitigations and controls that underpin the group's assessment of residual risk and reviews the group's current risk exposure and capability to identify new risks.

The Committee reviews promptly all material reports on the company from the internal auditors and ensures that appropriate action is taken on issues arising from such reports, including monitoring management's responsiveness to the findings and recommendations of the internal auditors.

The *Audit & Risk Committee* reviews the processes for dealing with complaints received by the company regarding accounting, internal accounting controls or auditing matters and the confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters (whistleblowing procedures), ensuring arrangements are in place for the proportionate, independent investigation and appropriate follow up of such matters. The effectiveness of the whistleblowing process as a whole and oversight of any complaints relating to governance matters is now reviewed by the *Nominating & Governance Committee* in line with its extended terms of reference. During the 2011 financial year, the Committee placed particular emphasis on reviewing major contract management and accounting, and the management of risk.

Following the review of the Committee's terms of reference, each Line of Business and internal service unit Chief Executive will attend meetings to discuss the key risks in their part of the business and the actions that are being taken to address them.

REPORT OF THE DIRECTORS REPORT OF THE AUDIT & RISK COMMITTEE

The annual meeting schedule has also changed to include an additional meeting which will focus solely on risk and the Group Chief Executive will attend to discuss the group's enterprise-wide risk management processes, the top risks facing the group as a whole and the group's risk appetite. Following this session, the Committee will submit their conclusions and any recommendations to the Board. Risk management is also given special attention by the Committee, devoting a significant proportion of their time to risk at the July and January meetings.

Committee activities

The Committee regularly reviews with the Director Internal Audit and appropriate executives, the implementation and effectiveness of key operational and functional change and remedial programmes. The Committee also sets time aside at each meeting to seek the views of the internal and external auditors in the absence of management.

During 2011 the *Audit & Risk Committee's* business included consideration of the following:

Month Consideration

April	<ul style="list-style-type: none"> BT Global Services major contract review Review of the internal control requirements under the Code including risk management processes Sarbanes-Oxley Act update Draft Annual Report & Form 20-F 2010 Going concern considerations.
May	<ul style="list-style-type: none"> Review of external audit and non-audit fees The Annual Report & Form 20-F 2010, full year results, announcement and related formal statements Corporation tax provisions Review of the internal control requirements under Sarbanes-Oxley Annual report on the performance of Internal Audit Internal Audit year end Corporate Summary Report Annual update on whistleblowing, litigation trends and major litigation report External auditors' report.
July	<ul style="list-style-type: none"> BT's risk management framework BT Security and Anti-Trust update First quarter results, announcement and related formal statements External auditors' report
September	<ul style="list-style-type: none"> Review of external auditors' effectiveness.
November	<ul style="list-style-type: none"> Review of fees for audit and non-audit services Half year results, announcement and related formal statements Going concern assessment External audit plan BT Global Services major contracts review Internal Audit Half-Year Performance Report Review of internal control requirements under the Code and Sarbanes-Oxley Annual review of Committee terms of reference External auditors' report
January	<ul style="list-style-type: none"> Internal Audit report Risk management review update

Audit Committee effectiveness
Sarbanes-Oxley update
Third quarter results, announcement and related formal statements
External auditors report
Annual review of accounting policies
BT Innovate & Design risk update.

The Committee also discussed the planning, conduct and conclusions of the external audit as it proceeded as explained below.

The Committee approved the auditor's group audit plan after discussion with them. The auditors explained the programme of work they planned to undertake to ensure that the identified risks did not lead to a material misstatement of the financial statements. Where they thought it would be effective to do so, this work included the evaluation and testing of the group's own internal controls. They also explained where they planned to obtain direct external evidence and were using experts to assist with their audit.

The Committee discussed these issues with them again at the time of their review of the half-year summary financial statements and again at the conclusion of their audit of the financial statements for the year. As they concluded the audit, they explained:

the work they had done to test management's assumptions and estimates and how they had satisfied themselves that these were reasonable;

they had reviewed the group's application of its accounting policies; and

the results of their testing of the controls and other procedures carried out in the major overseas locations and the issues they had found there.

The auditors also reported to the Committee the misstatements that they had found in the course of their work and the Committee confirmed that there were no such material items remaining unadjusted in the financial statements.

The Committee evaluated its performance and processes by inviting Committee members, key executives and the external auditors to complete questionnaires. The results showed that the Committee continued to be effective in terms of both behaviours and processes.

REPORT OF THE DIRECTORS

REPORT OF THE NOMINATING & GOVERNANCE COMMITTEE

Introduction

During the year it was agreed that the Committee should be renamed the *Nominating & Governance Committee* and, in addition to its existing remit, examine governance and compliance issues. It was also agreed that five regional governance committees (RGCs) would be established as sub-committees of the Committee.

The *Nominating & Governance Committee* is chaired by the Chairman. The other members are Tony Ball, Clay Brendish, Eric Daniels, Patricia Hewitt and Phil Hodgkinson.

Five of its six members are independent non-executive directors. Although he is not independent, the Board believes that Sir Michael Rake, as Chairman of the Board, is the most appropriate person to chair the Committee. He would not participate in the selection and appointment of his successor. The Company Secretary and, where appropriate, at the invitation of the Chairman, the Chief Executive attend the Committee's meetings.

Committee role

The Committee's terms of reference are available from the Company Secretary and are posted on our website at www.bt.com/committees. The *Nominating & Governance Committee* ensures an appropriate balance of experience and abilities on the Board, reviews the size and composition of the Board and recommends any proposed changes to the Board.

It also determines and reviews BT's governance policies including corporate governance, ethics, business principles, international trading regulation issues and data protection. The Committee met four times during the 2011 financial year.

Committee activities

Nominating

The Committee keeps under review the need to refresh the Board, prepares a description of the specific experience and skills needed for an appointment, considers candidates who are put forward by the directors and external consultants, and recommends to the Board the appointments of all directors after having met short-listed candidates. It makes recommendations to the Board on whether to reappoint non-executive directors at the end of terms of office. It also reviews the time required from the Senior Independent Director and other non-executive directors to carry out their duties and advises the Board on succession planning for the positions of the Chairman, Deputy Chairman and/or Senior Independent Director, Chief Executive and all other Board appointments.

The Committee reviewed the make-up and size of the Board and its committees, the overall governance framework, considered a proposal for the annual re-election of all directors and the appointment of external facilitators to carry out the next Board evaluation.

The Committee recommended:

the appointment of both Patricia Hewitt and Eric Daniels be extended for three years following the expiry of their respective initial three year terms

the appointment of Nick Rose as a non-executive director to strengthen the Board capability in the assessment of audit and risk issues, as he had held senior executive positions in various industries

the appointment of Jasmine Whitbread as a non-executive director to bring valuable experience to the Board on corporate responsibility, an area where she has held senior positions both in the UK and globally

the appointment of Carl Symon be extended for one year following the expiry of a nine year term and having reviewed his independence

the continuation of the Chairman in his role, having served for three years, following a review of his performance as part of the Board evaluation.

All appointments are subject to automatic termination in the event of a director not being re-elected by shareholders at the AGM.

Governance and compliance

The Committee receives regular reports on the effectiveness of and compliance with, BT's governance policies, reviews the corporate governance and decision making structure and processes throughout the group, including the regional approach to governance. It reviews the processes for, and effectiveness of, the whistleblowing procedures within BT and adopted a code of ethics for BT's Chief Executive, Group Finance Director and senior finance managers as required by the Sarbanes-Oxley Act. The Committee monitors corporate governance developments around the world and their impact on the business. It reviews the policy on where BT does business, the training and communication of governance and compliance, and the approach to appointments on subsidiaries and associated companies and conflicts of interest.

The Committee:

- recommended the formation of five RGCs namely: UK and Republic of Ireland; US and Canada; Latin America; Europe, Middle East and Africa; and AsiaPac and agreed their terms of reference;

- received a first report in relation to the establishment of each RGC;

- received a summary of the roll-out of BT's ethics adequate procedures programme; and

- reviewed the new whistleblowing procedures and confidential hotline.

The minutes of the *Nominating & Governance Committee* meetings are sent, at their request, to directors who are not members of the Committee, where appropriate to do so.

Board evaluation

A review was carried out in March and April 2010 by the Chairman and Company Secretary through a questionnaire and discussion and the results were discussed by the Board. A number of actions were implemented to address the points raised, namely:

- a review was undertaken of the composition of the Board and its Committees. A number of changes have been proposed which have been implemented;

- the remit of the *Audit & Risk Committee* has been extended to cover greater focus on risk management; and

- regular updates and training have been provided to the Board which have covered areas such as the UK Bribery Act 2010 and governance developments, and updates on particular areas of BT's business operations.

Following the Board evaluation, the Chairman reviewed the performance of each director and his own performance was reviewed by the Senior Independent Director in face-to-face meetings.

The Committee agreed that the next annual Board evaluation would be carried out using an external facilitator. Boardroom Review have been appointed and have begun a series of interviews which will lead to a report for discussion by the Board and an agreed set of actions.

A separate survey about *Audit & Risk Committee* effectiveness was also carried out and the outcome of the survey is in the Committee's report.

REPORT OF THE DIRECTORS

REPORT OF THE COMMITTEE FOR SUSTAINABLE & RESPONSIBLE BUSINESS

Introduction

The *Committee for Sustainable & Responsible Business* is chaired by the Chairman and comprises: Gavin Patterson, Chief Executive BT Retail; Larry Stone, President Group Public and Government Affairs; and Alex Wilson, Group Human Resources Director; three non-executive directors: Clay Brendish, Phil Hodgkinson and Jasmine Whitbread and three independent members: Lord Hastings, Baroness Jay and Dame Ellen MacArthur. Jonathon Porritt, chair of BT's external Leadership Advisory Panel (the Panel) of external sustainability experts, which provides advice on corporate responsibility (CR) issues, attends one meeting per year.

Committee role

With input and recommendations from executive management and advice from the Panel, the Committee sets the CR business strategy for the BT group globally (including wholly owned subsidiaries) for approval by the Board. The Committee reviews and agrees plans and targets, evaluates performance, oversees a culture of transparency and stakeholder accountability and distributes, within the approved budget, funding to support the strategy.

Committee activities

The Committee aims to ensure that BT's sustainable and responsible business practices are applied throughout the business, minimising any CR risks to BT's operations and reputation and maximising the opportunities to help create a better future. It encourages innovation and the development of new communications services to help create a more sustainable future for customers, employees and communities in the UK and around the world. The Committee met four times in the 2011 financial year and reviewed:

- the CR strategy and key performance indicators;

- community and charity support programmes;

- the development of BT's volunteering and sustainability skills programmes;

- activities supporting BT's environment and climate change programmes; and

- proposals relating to the development of BT's low carbon economy ICT solutions.

The Committee made visits to a number of organisations in the 2011 financial year, including NSPCC, Childline, Cancer Research UK, ICAN, The Communication Trust and the Pennies Foundation.

The Committee has close links with the Panel. Jonathon Porritt attended the December meeting of the Committee. Gavin Patterson attends Panel meetings.

REPORT OF THE DIRECTORS

REPORT ON DIRECTORS REMUNERATION

Overview

As outlined in the Chairman's message, the executive team has made considerable progress in a challenging year, achieving or exceeding demanding objectives for profitability and cash generation. The Chief Executive was therefore awarded a bonus of 126% of target (79% of the maximum opportunity), compared with 142% of target (71% of the maximum) for the previous year. Half of the bonus will be paid in cash and the remaining half will be deferred into shares receivable in three years' time, subject to continued employment as well as a clawback condition. Whilst customer service improved during the year, the level of improvement was insufficient to justify a payment for that component of the annual bonus.

During 2011 the Remuneration Committee reviewed the executive pay structure to ensure that it remains closely aligned to BT's corporate strategy and shareholders' interests. The Chair of the Committee led a consultation with major investors and representative bodies as part of the review.

The Committee agreed to maintain our policy position of setting basic salaries below the median of our comparator group, so that executive directors can only achieve upper quartile total rewards for exceptional performance in line with stretching performance targets.

As BT moves towards achieving profitable growth, alongside a continuing focus on customer service and cost transformation, the Committee decided to strengthen incentives for long-term performance. In particular, we will increase the element of the annual bonus dependent upon individual and role-specific performance aligned with our long-term strategy, and add a new measure of three-year revenue growth to the long-term incentive shares.

We have reviewed base salaries and, where appropriate, increased them to bring them closer towards, but still below or around median levels in comparable companies. In making these decisions, we took account of the position of all BT's employees who will benefit from pay increases and annual bonuses based on the company's performance in 2011.

BT's executive share plans reach the end of their 10-year life in October 2011. The Committee has agreed that renewed plans should be adopted, generally in the same form as the current plans but updated and amended to reflect best practice and current legislation. Shareholders will be asked to approve the adoption of the plans for a further 10 years at the 2011 Annual General Meeting.

Introduction

This report sets out the details of the remuneration policy for the company's directors and senior executives and the amounts paid to the directors in 2011. As well as meeting statutory requirements, the Remuneration Committee aims to comply with best practice guidelines and apply the principles of good corporate governance in producing this report. Relevant sections of this report have been audited in accordance with the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008.

Shareholders will be asked to vote on this Report at the 2011 AGM.

Remuneration policy

This part of the Report on directors' remuneration is not subject to audit.

Remuneration principles

Our policy remains to maintain a competitive remuneration package that will attract, retain and motivate a high quality top team, avoid excessive risk taking and align their interests with those of shareholders.

We believe in pay for performance. We aim to set base salaries below the median for our comparator group, while setting stretching goals for the annual bonus (including deferred shares) and the long-term incentive shares. It is only in return for sustained and excellent performance that the remuneration package as a whole will deliver upper quartile rewards.

A significant proportion of the total remuneration package is therefore variable and linked to corporate performance. The Committee reviews the performance targets regularly to ensure that they are both challenging and closely linked to the group's strategic priorities. Furthermore, because a large part of the remuneration package is delivered in shares and senior executives are required to build up a significant shareholding themselves, they are directly exposed to the same gains or losses as all other shareholders.

In setting directors' remuneration, the Committee takes account of the remuneration of other companies of similar size, complexity and geographic reach. The Committee also takes into account the pay and employment conditions of all our employees. For instance, the overall increase in senior managers' pay for 2011 was comparable with the pay settlement offered to our employees generally, with some senior managers receiving no increase. Salary increases for the executive directors are given on page 78.

BT operates in a number of different environments and has many employees who carry out diverse jobs across a number of countries.

all employees, including directors, are paid by reference to the market rate

performance is measured and rewarded through a number of performance-related bonus schemes across the group

business unit performance measures are cascaded down through the organisation

BT offers employment conditions that reflect our values and are commensurate with a large publicly listed company, including high standards of health and safety and equal opportunities

BT operates all-employee share plans which are open to all employees and executive directors alike

BT offers benefits which are available to everyone.

The Committee continues to keep under review the relationship of risk to remuneration and to seek input from the chairman of the *Audit & Risk Committee*. The largest single driver of on-target remuneration remains cash flow (24% of the Chief Executive's total package),

REPORT OF THE DIRECTORS REPORT ON DIRECTORS REMUNERATION

reflecting the importance of cash flow to invest in the business, reduce net debt, support the pension fund and pay progressive dividends. In deciding to include three-year revenue growth as a new measure for the long-term incentive shares, we considered carefully the possible risk of incentivising unprofitable revenue growth. We believe, however, that the continued inclusion of total shareholder return (TSR) and free cash flow performance measures, the inclusion of earnings per share (EPS) in the annual bonus plan and the Board's focus on profitable growth will sufficiently mitigate this risk.

The Committee is also satisfied that the incentive structure for senior executives does not raise environmental, social or governance risks by inadvertently motivating irresponsible behaviour. Part of the annual bonus depends upon an individual assessment of each senior executive's personal contribution to environmental, social and governance measures, including results of the regular employee surveys and health and safety outcomes.

The Committee has reaffirmed its position that the Board and Remuneration Committee have absolute discretion to reduce variable compensation in the light of risk and the Group's overall performance. We would only use this in exceptional circumstances.

Role of the Remuneration Committee

The Remuneration Committee is a formal committee of the Board and has powers delegated to it under the Articles of Association. Its remit is set out in the terms of reference formally adopted by the Board, which were last reviewed in December 2010.

The terms of reference of the Committee are available on the company's website at www.bt.com/committees

The Remuneration Committee agrees the framework for the remuneration of the Chairman, the executive directors and certain senior executives. This includes the policy for all cash remuneration, executive share plans, service contracts and termination arrangements. The Committee approves salaries, bonuses and share awards for executive directors and certain senior executives. The Committee approves new executive share plans and any changes and makes recommendations to the Board which require shareholder approval. The Committee also determines the basis on which awards are granted under the executive share plans to executives reporting to the senior management team. The Board has reviewed compliance with the Combined Code on Corporate Governance on reward-related matters, and confirms that the company has complied with all aspects of the Code.

The Committee met six times during 2011. The Committee is chaired by Patricia Hewitt, the Senior Independent Director. The current members of the Committee are all independent non-executive directors. The other members who served during 2011 were:

Eric Daniels

Carl Symon

Sir Michael Rake (member until 31 May 2010).

In addition, the Chairman and Chief Executive are invited to attend meetings, except when it would be inappropriate for them to be there, for example, when their own remuneration is discussed. Non-executive directors who are not members of the Committee are entitled to receive the papers discussed at meetings and the minutes. In view of the growing demands on remuneration committees from corporate governance requirements, the Committee has been strengthened by the addition of a new member, Tony Ball, with effect from 5 May 2011.

The Committee has received advice during the year from independent remuneration consultants, Towers Watson, who were appointed by the Committee. Towers Watson attended Committee meetings when major remuneration issues were discussed. Towers Watson also provide the company with consultancy services on general human resources (HR) and pensions issues. The Committee regularly consults the Chief Executive, the Group HR Director, the Director Reward and Employee Relations, and the Company Secretary.

The chair of the Committee meets major shareholders, the Association of British Insurers, Risk Metrics (RREV) and Pensions Investment Research Consultants Limited (PIRC) to discuss remuneration issues, on a regular basis.

The Committee reviews its own performance regularly and takes steps to improve its effectiveness.

Remuneration in 2011

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The table below summarises the component parts of the remuneration package in 2011. This includes bonuses earned for performance during 2011, payouts received from and awards granted under the executive share plans.

	Ian Livingston	Tony Chanmugam	Gavin Patterson
Base salary	£892,000	£504,000	£521,000
Annual bonus			
Cash	£1,415,250	£604,350	£645,750
Deferred shares	726,514 shares ^a	232,680 shares ^a	248,620 shares ^a
Pension^b	£32,000	£151,000	£104,000
Other benefits	Company car, fuel or driver, personal telecommunications facilities, medical cover, financial planning		
Incentive shares awarded	1,675,769 shares	707,546 shares	744,786 shares
vested			
lapsed	1,499,425	155,818	735,010
Deferred shares vested	142,312 shares	38,422 shares	58,931 shares
Shareholding requirement	200% salary	150% salary	150% salary

^a Awards of deferred shares are expected to be granted in June 2011. An indication of the number of shares to be granted has been calculated by using the share price (194.8p) on 6 May 2011.

^b Pension allowance paid in cash for 2011

see Pensions on
page 78.

70

REPORT OF THE DIRECTORS REPORT ON DIRECTORS REMUNERATION**Salaries**

Salaries are reviewed annually but increases are made only where the Committee believes the adjustments are appropriate. In 2011 salaries of the directors were increased to reflect the contribution of the individual, increased responsibilities and market conditions.

Annual bonus

Executive directors are eligible for an annual bonus, based upon corporate performance targets, environmental, social and governance performance and achievement of personal and role-specific objectives. The structure of the annual bonus, approved by shareholders in 2008 and subsequently introduced in phases, is as follows:

	Chief Executive	Executive directors
Annual cash bonus	target 125% salary maximum 200% salary	target 100% salary maximum 150% salary
Deferred bonus into shares	target 125% salary maximum 200% salary	target 75% salary maximum 112.5% salary
Total bonus	target 250% salary maximum 400% salary	target 175% salary maximum 262.5% salary

Following our review, the Committee decided to leave this structure unchanged.

The deferred shares, which are based on the same performance criteria as the cash bonus, are, of course, subject to continued employment as well as to clawback, see **Clawback** on page 73.

Targets for the annual bonus are set at the beginning of the financial year. For 2011, the weighting of the bonus targets were set as follows:

STRUCTURE OF ANNUAL BONUS 2011

ADJUSTED EARNINGS PER SHARE (EPS)	30%
	+
REPORTED FREE CASH FLOW	30%
	+
CUSTOMER SERVICE IMPROVEMENT	20%
	+
ENVIRONMENTAL, SOCIAL AND GOVERNANCE OBJECTIVES (ESG)	10%
	+
ROLE-SPECIFIC OBJECTIVES	10%
	=
TOTAL	100%

The scores for corporate performance targets for 2011 (see **Our strategy** on page 6) were as follows:

Measure (weighting)	Threshold	Target	Maximum	Actual
---------------------	-----------	--------	---------	--------

EPS (30%)	15%	30%	60%	60%
Free cash flow (30%)	15%	30%	60%	60%
Customer service (20%)	10%	20%	40%	0%
Sub-total				120%
ESG (10%)	5%	10%	20%	a
Role-specific objectives (10%)	5%	10%	20%	a

^a Performance is assessed on an individual basis.

The two financial targets (which together represent 60% of the bonus) have a direct impact on shareholder value, while customer service and broader objectives are vital to the company's long-term health and growth. We do not publish details of the EPS and cash flow targets, since these are market sensitive and commercially confidential. The Committee is, however, satisfied that the measures are appropriate and that the targets are properly stretching. In calculating EPS for purposes of the annual bonus, volatile items which would be reported under IFRS are excluded. The impact of market movements in foreign exchange and financial instruments, plus the net finance expense or income relating to the group's pension liabilities, were excluded from the target.

Customer service is measured by rigorous and challenging 'right first time' metrics across each line of business. Although we will keep this measure under review, 'right first time' is directly linked to cost reductions as well as to customer satisfaction and is measured objectively. As explained by the Chief Executive in his introduction to the **Business review** on page 9, the company did not always deliver on its promises to customers during 2011; as a result, no payment for the customer service component of the annual bonus will be made.

The environmental, social and governance measure is assessed by the Chief Executive for each senior executive, and by the Chairman for the Chief Executive himself. Assessment is based upon BT's regular employee survey as well as health and safety and sustainability measures.

In 2011 we introduced a new measure, worth 10% of the bonus, relating to individual performance against personal and role-specific objectives based on the company's strategic priorities.

Annual bonuses are paid in cash and deferred shares. Details of the bonuses for Ian Livingston, Tony Chanmugam and Gavin Patterson are set out in the table on page 77.

Annual bonuses are not pensionable.

Deferred shares

As shown in the table above, part of an executive director's annual bonus is deferred into shares. The number of shares under each award is calculated using the average market price of BT shares on the three dealing days preceding the date of grant.

The shares vest and are transferred to the executive after three years if they remain employed by the company. There are no additional performance measures for the vesting of deferred shares but they are subject to clawback. There is no subsequent matching of deferred shares. The Committee considers that awarding shares on a deferred basis acts as a retention measure and contributes to the alignment of management with the long-term interests of the shareholders.

The deferred share awards for previous years for Ian Livingston, Tony Chanmugam and Gavin Patterson at the end of 2011 are contained in the table on page 81.

REPORT OF THE DIRECTORS REPORT ON DIRECTORS REMUNERATION

Incentive shares

The Chief Executive received an award of incentive shares with a value equivalent to 2.5x salary (2010: 3x salary).

Other executive directors received awards with a value of 2x salary (2010: 2.5x salary).

The details of all the awards of incentive shares held by Ian Livingston, Tony Chanmugam and Gavin Patterson at the end of the 2011 financial year are contained in the table on page 80. Awards of incentive shares granted in 2011 are given in the table on page 70.

Remuneration in 2012

During 2011 the Remuneration Committee reviewed the senior executive remuneration package, taking into account the challenges to the business, our strategic priorities, the need to ensure alignment with shareholders' interests and the other general principles on which we base executive pay. In particular, as BT moves towards achieving profitable growth, alongside a continuing focus on customer service and cost transformation, the Committee decided to strengthen incentives for long-term performance. As part of the review, we conducted an extensive and helpful consultation with institutional shareholders and representative bodies.

The Committee decided to implement the following changes in 2012:

At present, incentive shares are based equally on relative total shareholder return (TSR) and three-year free cash flow. We will retain both measures, which are critical to delivering shareholder value. In order to increase the alignment of pay with our focus on long-term profitable growth, we will also introduce a further measure, worth 20%, based on long-term revenue growth. The remaining 80% will be split equally between TSR and free cash flow.

The new revenue growth measure is based on underlying revenue excluding transit revenue as transit traffic is low-margin and is significantly affected by reductions in regulatory mobile termination rates which have no impact on the group's profitability.

Our policy is to set measures for the incentive shares for free cash flow and long-term revenue growth so that they are appropriately stretching. The threshold performance level, which must be achieved before shares vest, is established above market expectations when targets are set and the maximum award is only available for outstanding performance. The Committee has decided that the revenue element of the award will begin to vest only if revenue in 2014 is higher than the baseline of 2011. In the face of a tough regulatory environment and intense competition, the Committee believes that the targets they have set for remuneration purposes are very challenging.

In order to allow greater differentiation between individuals' contribution to the company's strategic priorities, we will increase the weighting in the annual bonus on personal and role-specific objectives aligned with our strategy. For the Chief Executive and Group Finance Director, corporate performance (EPS, free cash flow and customer service) will represent 75% of the scorecard; personal and role-specific objectives aligned with our strategy 15%, and ESG performance 10%. For the other executive director, 60% will be linked to corporate objectives, 15% to business unit objectives, 15% to personal objectives and 10% to ESG performance.

In order to strengthen the alignment with shareholders' interests, the customer service element of the annual bonus will only be paid if the minimum EPS threshold is also achieved.

The Committee believes that the group performance targets for 2012 are very challenging.

The Committee has considered carefully the relationship of risk to remuneration. The Committee is satisfied that this spread of measurement criteria does not drive inappropriate and risky behaviour and that they are aligned to shareholders' interests.

Base salaries have also been reviewed and, where appropriate, increased to bring them more closely towards, but still typically below or around, mid-market levels in comparable companies. In making these decisions, the Committee

took account of the position of all BT's employees who will benefit from pay increases and annual bonuses based on the company's performance in 2011.

The structure of the annual bonus (cash and deferred shares) is unchanged for 2012. The value of awards of incentive shares is also unchanged for 2012.

No retention awards or share options will be granted.

Proportion of fixed and variable remuneration

The composition of each executive director's performance-related remuneration, excluding pension, is as follows:

Ian Livingston

Tony Chanmugam

Gavin Patterson

a Target

remuneration
comprises
current base
salary, on-target
annual bonus
and the expected
value of awards
under the
deferred bonus
and incentive
share plans.

b Actual

remuneration
comprises base
salary, actual
cash bonus and
the value
received from
deferred shares
and incentive
shares (awards
granted in 2007
and vested in
2010) during the
financial year.

Long-term share-based incentives

Incentive shares

BT operates a long-term Incentive Share Plan (incentive shares), based on performance over three years. Shares only vest if the participant is still employed by BT and challenging performance measures have been met. For awards granted in 2008*, the vesting of awards was based entirely on TSR relative to a comparable group of companies; in 2009 and 2010, 50% of awards are based on relative TSR with the balance based on a three-year cumulative free cash flow measure. The use of a free cash flow measure for the long-term incentive plan as well as for the annual bonus reflects the importance of cash generation over both the short and medium term.

*For the grant of
share awards
and options,

references to
2008, 2009, etc.,
are to the
calendar year
and not the
financial year.

REPORT OF THE DIRECTORS **REPORT ON DIRECTORS** **REMUNERATION**

TSR for these purposes was calculated by JPMorgan Cazenove. TSR links the reward given to directors with the performance of BT against other major companies. TSR is measured against a comparator group which contains European telecommunications companies and companies which are either similar in size or market capitalisation and/or have a similar business mix and spread to BT.

The TSR comparator group for awards to be granted in 2011 comprises the following companies:

Accenture	France Telecom	Telecom Italia
AT & T	Hellenic Telecom	Telefónica
Belgacom	IBM	Telekom Austria
BSkyB	National Grid	Telenor
BT Group	Portugal Telecom	TeliaSonera
Cable & Wireless Worldwide	Royal KPN	Verizon
Cap Gemini	Swisscom	Virgin Media
Centrica	TalkTalk	Vodafone
Deutsche Telekom		

The TSR comparator group was the same for awards granted in 2010. In 2009, Cable & Wireless Worldwide replaced Cable & Wireless and TalkTalk replaced Carphone Warehouse.

The TSR for a company is calculated by comparing the return index (RI) at the beginning of the performance period with the RI at the end of the period. The RI is the TSR value of a company measured on a daily basis, as tracked by independent analysts, Datastream. It uses the official closing prices for a company's shares, adjusted for all capital actions and dividends paid. The initial RI is determined by calculating the average RI value taken daily over the three months prior to the beginning of the performance period; and the end value is determined by calculating the average RI over the three months up to the end of the performance period. This mitigates the effects of share price volatility. A positive change between the initial and end values indicates growth in TSR.

Historical vesting for executive share plans

Performance conditions for the incentive shares and share options are challenging as demonstrated by the table below. Relative TSR has been the measure for many years. This measure has been retained under the current remuneration policy although a free cash flow measure was added for awards granted in 2009 and 2010, and in 2011 there will be an additional revenue measure.

For recent awards, both TSR and cash flow performance have improved when compared with the last five years and recent awards are projected to vest at higher levels than the awards for the period from 2004 to 2008 as shown below. The following table shows the vesting levels of BT's incentive share awards and share options granted to executives since 2004.

Year of	Performance	Incentive shares	Share options percentage
---------	-------------	------------------	--------------------------

grant	period	percentage vesting	vesting
2004	2004-2007	55%	58%
2005	2005-2008	25%	
2006	2006-2009	0%	
2007	2007-2010	0%	
2008	2008-2011	0%	
Average annual vesting		16%	

No share options have been granted since 2004.

At 31 March 2011, the TSR for the awards granted in 2008 was at 9th position against the comparator group of 15 companies. As a result, none of the shares will vest and all of the share awards have lapsed.

TSR vesting schedule for awards of incentive shares granted in 2009 and 2010

The following table shows the potential vesting of awards granted in 2009 and 2010 based on performance to date. The remaining 50% of the awards of incentive shares are based on a three-year cumulative cash flow measure. For awards to be granted in 2011, there will be an additional measure of revenue growth over three years, which will form 20% of the measure. The TSR and cash flow measures will each be reduced to 40% of the total measure.

The Committee believes that the free cash flow and revenue performance measures are challenging and the financial performance necessary to achieve awards towards the upper end of the range for each target is stretching. Targets for threshold performance have been established at above market consensus at the time when they were set.

Clawback

The rules of the executive share plans provide for a clawback of unvested awards in circumstances where the Committee becomes aware of facts which would, in its discretion, justify such reduction.

Retention shares

Awards of retention shares are used by exception only and principally as a recruitment or retention tool. As a result, shares currently under award are not generally subject to a corporate performance target. The length of the retention period before awards vest is flexible, although this would normally be three years unless the Committee agrees otherwise. The shares are transferred at the end of the specified period if the individual is still employed by BT and any performance conditions are met. No awards of retention shares were made to executive directors, but one award was granted to a senior executive in the 2011 financial year.

Share options

No share options have been awarded under the Global Share Option Plan (GSOP) since 2004.

Details of options held by directors at the end of 2011 are contained in the table on page 79.

Renewal of executive share plans

The four executive share plans, the BT Group Incentive Share Plan, the BT Group Deferred Bonus Plan, the BT Group Retention Share

REPORT OF THE DIRECTORS REPORT ON DIRECTORS REMUNERATION

Plan and the BT Group Global Share Option Plan reach the end of their 10 year life in October 2011.

The Remuneration Committee has agreed that these plans, together the BT Executive Portfolio, should be renewed to deliver share awards as part of the senior executive remuneration package. Accordingly, shareholders will be asked to approve adoption of renewed plans at the AGM in 2011. The renewed plans will be in substantially the same form and have been updated to reflect changes in legislation, best practice and market developments. No material changes to the plans have been made.

Other share plans

The Chairman and executive directors may participate in BT's all-employee share plans, the Employee Sharesave Scheme, Employee Share Investment Plan (ESIP) and Allshare International, on the same basis as other employees. Details of these plans are disclosed in note 6 to the consolidated financial statements.

Dilution

Treasury shares are generally used to satisfy the exercise of share options, the grant of share awards and for the all-employee share plans. At the end of the 2011 financial year, treasury shares equivalent to 9% of the issued share capital would be required for these purposes. It is estimated that treasury shares equivalent to approximately 1% of the issued share capital will be required for all the employee share plans in 2012.

Other matters

Executive share ownership

The Committee believes that the interests of the executive directors should be closely aligned with those of shareholders. The deferred shares and incentive shares provide considerable alignment. The directors are encouraged to build up a shareholding in the company over time by retaining shares which they have received under an executive share plan (other than shares sold to meet a National Insurance or income tax liability) or from a purchase in the market. The Chief Executive is required to build up a shareholding of 2x salary and the remaining directors 1.5x salary. Progress towards meeting these targets has been made in 2011.

Current shareholdings are set out on page 76.

Pensions

The BT Pension Scheme (BTPS) closed to new entrants on 31 March 2001. None of the executive directors participates in future service accrual in the BTPS although Tony Chanmugam's pension is based on final salary. Executive directors who are members of the BTPS also benefit from a death in service lump sum of four times salary. All new employees are eligible to join the defined contribution BT Retirement Saving Scheme (BTRSS), the successor to the defined contribution BT Retirement Plan (BTRP). The BTRSS is a group personal pension plan. For executive directors the company agrees to pay a fixed percentage of the executive's salary each year which can be put towards the provision of retirement benefits. Executive directors who are not members of BTPS benefit from a death in service lump sum of four times salary and a dependant's pension of 30% of capped salary.

Pension provision for all executives is based on salary alone – bonuses, other elements of pay and long-term incentives, are excluded.

Other benefits

Other benefits for the Chairman and the senior management team include some or all of the following: company car, fuel or driver, personal telecommunications facilities and home security, medical and dental cover for the director and immediate family, special life cover, professional subscriptions, and personal tax advice and financial counselling. The company has a permanent health insurance policy to provide cover for the Chairman and certain executive directors who may become permanently incapacitated.

Service agreements

It is group policy for the Chairman and executive directors to have service agreements providing for one year's notice by the company and six months' notice by the director. All of the service agreements contain provisions dealing with the removal of a director for poor performance, including in the event of early termination of the contract by BT. The contracts of the Chairman, Ian Livingston, Tony Chanmugam and Gavin Patterson entitle them on termination of their contract by BT to payment of salary and the value of benefits (pension benefits (including life cover), health cover, dental cover and car) until the earlier of 12 months from notice of termination or the director obtaining full-time

employment. No director will receive a bonus or other payments on a change of control.

Outside appointments

The Committee believes that there are significant benefits, to both the company and the individual, from executive directors accepting non-executive directorships of companies outside BT. The Committee will consider up to two external appointments (of which only one may be to the Board of a major company), for which a director may retain the fees. Ian Livingston receives an annual fee of £25,000 as a non-executive director of Celtic and an additional annual fee of £5,000 for chairing the audit committee. Tony Chanmugam is a non-executive director and chairman of the audit committee of Barnet and Chase Farm Hospital Trust, for which he receives an annual fee of £6,096 which is donated to charity. On 1 February 2011, Gavin Patterson was appointed as a non-executive director of British Airways for which he receives an annual fee of £50,000.

Non-executive directors letters of appointment

Non-executive directors have letters of appointment. They are appointed for an initial period of three years. During that period, either party can give the other at least three months notice. At the end of the period, the appointment may be continued by mutual agreement. Further details of appointment arrangements for non-executive directors are set out in **BT's non-executive directors** on page 63. The letters of appointment of non-executive directors are terminable on notice by the company without compensation. The letters of appointment are open for inspection by the public at the registered office of the company.

Non-executive directors remuneration

Eight of the directors on the Board are non-executive directors who, in accordance with BT's articles of association, cannot individually vote on their own remuneration. Non-executive remuneration is reviewed by the Chairman and the Chief Executive, and discussed and agreed by the Board. Non-executive directors may attend the Board discussion but may not participate in it.

The Board reviewed and increased the fees for the non-executive directors in January 2011. The fees had not previously been increased since January 2008. Increases in the fees were consistent with salary levels and increases for the broader employee population. The fees of the non-executive directors will be reviewed annually in the future.

REPORT OF THE DIRECTORS REPORT ON DIRECTORS REMUNERATION

The basic fee for non-executive directors is £62,000 per annum (2010: £60,000). There are additional fees for membership and chairing a Board committee, details of which are given in the table below:

Committee	Member s fee	Additional Chairman s fee
Audit & Risk	£ 15,000	£ 15,000
Remuneration	£ 10,000	£ 10,000
Nominating & Governance	£7,500	£5,000
Other Board committees	£5,000	£5,000

Patricia Hewitt, as Senior Independent Director, chair of the Remuneration Committee, chair of the Pension Scheme Performance Review Group and a member of the Audit & Risk Committee, receives total fees of £159,500 per annum. Carl Symon receives an additional annual fee of £72,500 as chairman of the Equality of Access Board (a Board committee).

An additional fee of £2,000 per trip is paid to those non-executive directors travelling regularly from overseas to Board and Board committee meetings on an inter-continental basis.

To align further the interests of the non-executive directors with those of shareholders, the company's policy is to encourage these directors to purchase, on a voluntary basis, BT shares to the value of £5,000 each year. The directors are asked to hold these shares until they retire from the Board. This policy is not mandatory. Current shareholdings are shown on page 76.

No element of non-executive remuneration is performance-related. Non-executive directors do not participate in BT's bonus or employee share plans and are not members of any of the company pension schemes.

Directors' service agreements and contracts of appointment

The dates on which directors' initial service agreements/letters of appointment commenced and the current expiry dates are as follows:

Chairman and executive directors	Commencement date	Expiry date of current service agreement or letter of appointment
Sir Michael Rake	26 September 2007	
I Livingston	1 June 2008	The contract is terminable by the company on 12 months' notice and by the director on six months' notice.
T Chanmugam	1 December 2008	
G Patterson	1 June 2008	
Non-executive directors		
C Brendish	1 September 2002	Letter of appointment was for an initial period of three years. The appointment was extended for three years in 2005 and by a further three years in 2008. The appointment will terminate on 31 August 2011. The appointment is terminable by the company or the director on three months' notice.
C G Symon	14 January 2002	

		Letter of appointment was for an initial period of three years. The appointment was extended for three years in 2005 and by a further three years in 2008. The appointment was extended in January 2011 for 12 months. The appointment will terminate on 13 January 2012. The appointment is terminable by the company or the director on three months' notice.
P Hodgkinson	1 February 2006	Letter of appointment was for an initial period of three years. The appointment was extended for three years in 2009. The appointment is terminable by the company or the director on three months' notice.
J E Daniels P Hewitt	1 April 2008 24 March 2008	Letters of appointment were for an initial period of three years and are terminable by the company or the director on three months' notice. The appointments were extended for three years in March 2011.
T Ball	16 July 2009	Letter of appointment is for an initial period of three years. The appointment is terminable by the company or the director on three months' notice.
N Rose J Whitbread	1 January 2011 19 January 2011	Letters of appointment are for an initial period of three years. The appointments are terminable by the company or the director on three months' notice.

There are no other service agreements or material contracts, existing or proposed, between the company and the directors.

There are no arrangements or understandings between any director or executive officer and any other person pursuant to which any director or executive officer was selected to serve. There are no family relationships between the directors.

REPORT OF THE DIRECTORS **REPORT ON DIRECTORS** **REMUNERATION****Directors' interests**

The interests of directors holding office at the end of the year, and their families, in the company's shares at 31 March 2011 and 1 April 2010, or at date of appointment if later, are shown below:

Beneficial holdings	Number of shares	
	2011	2010
Sir Michael Rake	109,710	108,362
I Livingston ^a	1,155,545	1,084,513
T Chanmugam ^a	224,416	205,629
G Patterson ^a	439,473	409,181
T Ball	15,000	15,000
C Brendish	44,670	41,920
J E Daniels	12,647	12,647
P Hewitt	12,391	10,554
P Hodkinson	16,683	16,683
N Rose ^b	50,000	
C G Symon	20,056	20,056
J Whitbread ^c	640	
Total	2,101,231	1,924,545

^a Includes free shares awarded under the ESIP.

^b Nick Rose was appointed on 1 January 2011.

^c Jasmine Whitbread was appointed on 19 January 2011.

During the period from 1 April 2011 to 6 May 2011, there were no movements in directors' beneficial holdings. The directors, as a group, beneficially own less than 1% of the company's shares.

Performance graph

This graph illustrates, as required by the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008, the performance of BT Group plc measured by TSR relative to a broad equity market index over the past five years. We consider the FTSE 100 to be the most appropriate index against which to measure performance for these purposes, as BT has been a constituent of the FTSE 100 throughout the five-year period, and the index is widely used. TSR is the measure of the returns that a company has provided for its shareholders, reflecting share price movements and assuming reinvestment of dividends.

31 March 2006 = 100

Source:

Datastream

The graph shows the relative TSR performance of BT and the FTSE 100 over the past five years.

76

REPORT OF THE DIRECTORS REPORT ON DIRECTORS REMUNERATION**Remuneration review**

The remainder of the Report on directors remuneration is subject to audit.

Directors' emoluments

Directors' emoluments for the financial year 2011 were as follows:

	Basic salary and fees £000	Pension allowance net of pension contributions ^a £000	Total salary and fees £000	Annual bonus cash £000	Expense allowance £000	Other benefits excluding pension £000	Total 2011 £000	Total 2010 £000	Deferred shares ^b 2011 £000	2010 £000
Sir Michael Rake ^c	613		613			25	638	670		
I Livingston ^c	892	32	924	1,415		20	2,359	2,105	1,415	1,206
T Chanmugam ^{c,d,e}	504	151	655	604	19	12	1,290	1,109	453	346
G Patterson ^{c,d}	521	104	625	645	19	11	1,300	1,133	484	365
T Ball	73		73				73	53		
C Brendish	82		82				82	80		
J E Daniels	76		76				76	75		
P Hewitt	152		152				152	128		
P Hodgkinson	102		102				102	100		
N Rose ^f	16		16				16			
C G Symon ^g	152		152			16	168	174		
J Whitbread ^h	14		14				14			
	3,197	287	3,484	2,664	38	84	6,270	5,627	2,352	1,917

**Termination
payments**

H Lalaniⁱ

612 131

6,882 5,758

^a Pension allowance paid in cash for 2011 see Pensions on page 78.

^b Deferred annual bonuses payable in shares in three years time, subject to continued employment.

^c

Other benefits include some or all of the following: company car, fuel or driver, personal telecommunications facilities and home security, medical and dental cover for the directors and immediate family, special life cover, professional subscriptions, personal tax advice, and financial counselling.

^d Expense allowance in the above table includes a monthly cash allowance in lieu of a company car or part of such allowance which has not been used for a company car.

^e Tony Chanmugam was granted a retention cash award in early 2008 prior to his appointment as a director. He received a payment of £315,000 in May 2010.

^f Nick Rose was appointed as a director on 1 January 2011.

^g Includes an additional fee for regular travel to Board and Board committee meetings.

^h Jasmine Whitbread was appointed as a

director on 19
January 2011.

- i Hanif Lalani's contract was terminated on 11 January 2010. In accordance with his contract, his salary of £585,000 per annum and the value of his benefits to which he was entitled amounting to £195,000 per annum, continued to be provided until 10 January 2011.

REPORT OF THE DIRECTORS REPORT ON DIRECTORS REMUNERATION

The annual cash bonus awards for 2011 are not pensionable. Ian Livingston's bonus of £1,415,250 represented 157.25% of his current salary (2010: 142%), Tony Chanmugam's bonus of £604,350 represented 118.5% of his current salary (2010: 97%) and Gavin Patterson's bonus of £645,750 represented 123% of his current salary (2010: 97%). Following this year's review of annual salaries, Ian Livingston's salary will be increased to £925,000 (2.8%), Tony Chanmugam's salary will be increased to £535,000 (4.9%) and Gavin Patterson's salary will be increased to £570,000 (8.6%). All increases will be effective from 1 June 2011.

Salary increases for direct reports to the Chief Executive (including the executive directors) were consistent with the salary increases for employees throughout the company.

Sir Michael Rake's salary was increased from £600,000 to £650,000 with effect from 1 January 2011, the first increase since his appointment as Chairman in September 2007. His salary will be reviewed again in January 2012. This increase is consistent with salary increases for employees over the same period.

Former directors

Sir Peter Bonfield received under pre-existing arrangements, a pension of £403,745 in 2011 (2010 £394,283).

Baroness Jay retired as a non-executive director on 13 January 2008 but continues as a member of the *Committee for Sustainable & Responsible Business* for which she receives an annual fee of £6,500.

Deborah Lathen retired as a director on 31 January 2010 and she received an annual fee of US\$70,000 (£42,000) as a consultant to BT.

Hanif Lalani, who resigned as a director on 7 January 2010, will receive a deferred pension under the BTPS on his 60th birthday.

Loans

There are no outstanding loans granted by any member of the BT Group to any of the directors, or guarantees provided by any member of the BT Group for their benefit.

Pensions

Sir Michael Rake is not a member of any of the company pension schemes, and the company made no payments towards retirement provision. BT provides him with a lump sum death in service benefit of £1m.

Ian Livingston is not a member of any of the company pension schemes, but the company has agreed to pay an annual amount equal to 30% of his salary towards pension provision. The company paid £234,750 into his personal pension plan, plus a cash payment of £32,250 representing the balance of the pension allowance for the 2011 financial year. BT also provides him with a death in service lump sum benefit of four times his salary.

Tony Chanmugam is a member of the BTPS but has opted out of future pensionable service accrual. The company pays him an annual allowance equal to 30% of salary towards pension provision. A cash payment of £151,250 was made for him for the 2011 financial year. BT also provides him with a death in service lump sum benefit of four times his salary.

Gavin Patterson receives an annual allowance equal to 30% of salary towards pension provision. Of this amount, £52,080 was paid as an employer contribution into the BTRSS and the balance of £104,160 was paid as a cash payment for the 2011 financial year. BT also provides him with a death in service lump sum benefit of four times his salary plus a widow's pension of 30% of his capped salary.

The table below shows the increase in the accrued benefits, including those referred to above, to which each director who is a member of the BTPS has become entitled during the year, and the transfer value of the increase in accrued benefits.

Increases in pension benefits at 31 March 2011

Change	Transfer value of increase in accrued
Additional	

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	Accrued pension		Transfer value of accrued benefits		in transfer value c-d less director s contributions	accrued benefits earned in the year	benefits in e less director s contributions
	2011 £000 ^a	2010 £000 ^b	2011 £000 ^c	2010 £000 ^d	2011 £000	2011 £000 ^e	2011 £000 ^f
T Chanmugam ^g	191	180	4,197	3,536	661	3	51

^{a-d} As required by the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008.

^{a-b} The values represent the deferred pension to which he would have been entitled had he left the company on 31 March 2011 and 2010, respectively.

^c Transfer value of the deferred pension in column (a) as at 31 March 2011 calculated on the basis of actuarial advice in accordance with relevant legislation. The transfer value represents a liability of the

BTPS rather than any remuneration due to the individual, and cannot be meaningfully aggregated with annual remuneration, as it is not money the individual is entitled to receive.

^d The equivalent transfer value but calculated as at 31 March 2010 on the assumption that the director left the company on that date.

^e The increase in pension built up during the year, net of inflation. The gross amount can be calculated by deducting the amount under column (b) from the amount under column (a).

^f The transfer value of the pension in column (e), less directors contributions.

^g Tony Chanmugam's contributions in the financial year 2011 were

£nil (2010: £nil).

REPORT OF THE DIRECTORS REPORT ON DIRECTORS REMUNERATION
Share options held at 31 March 2011, or date of appointment if later

	1 April 2010 or date of appointment if later	Number of shares under option			Option price per share	Usual date from which exercisable	Usual expiry date
		Granted	Lapsed	Exercised			
				31 March 2011			
Sir Michael Rake	12,110 ^a			12,110	68p	01/08/2012	01/02/2013
		1,485 ^b		1,485	104p	01/08/2015	01/02/2017
I Livingston	12,110 ^a			12,110	68p	01/08/2012	01/02/2013
T Chanmugam	37,384 ^c			37,384	192p	24/06/2007	24/06/2014
	12,110 ^a			12,110	68p	01/08/2012	01/02/2013
G Patterson	98,178 ^c			98,178	192p	24/06/2007	24/06/2014
Total	171,892			173,377			

All of the above options were granted for nil consideration.

^a Option granted on 7 April 2009 under the Employee Sharesave Scheme, in which all employees of the company are entitled to participate.

^b Option granted on 17 June 2010 under the Employee Sharesave Scheme, in

which all employees of the company are entitled to participate.

- ^c Options granted under the GSOP on 24 June 2004. The exercise of options was subject to a performance measure being met. The performance measure is relative TSR compared with a group of 20 companies from the European Telecom Sector as at 1 April 2004. BT's TSR had to be in the upper quartile for all the options to become exercisable. At median, 30% of the options would be exercisable. Below that point none of the options could be exercised. The three-year performance period ended on 31 March 2007. At that date, the company was at 8th position against the comparator group and as a result, 42% of each options

lapsed and 58%
of each option
became
exercisable on
24 June 2007.

Note: Hanif Lalani, a former director who left the company on 31 March 2010, had an option over 90,625 shares with an option price of 192p per share and an option over 105,264 shares at 199.5p per share, which were preserved until 31 March 2011. Both options lapsed on 31 March 2011.

The market price of BT shares at 31 March 2011 was 185.6p (2010: 123.9p) and the range during 2011 was 109.9p to 191.1p (2010: 79.7p - 149.6p).

REPORT OF THE DIRECTORS REPORT ON DIRECTORS REMUNERATION**Share awards under long-term incentive plans held at 31 March 2011, or date of appointment, if later**

Details of the company's ordinary shares provisionally awarded to directors, as awards of incentive shares are as follows:

	1 April 2010	Dividends Awarded	de-invested & Vested	Lapsed	Total number of award shares 31 March 2011	Vesting date	Monetary value of Market tested Price award at vesting £000
I Livingston							
2008 ^a	1,433,332		66,093	1,499,425		31/3/2011	203p
2009 ^b	2,037,329		93,945		2,131,274	31/3/2012	128.41p
2010 ^c		1,675,769	77,273		1,753,042	31/3/2013	134.26p
T Chanmugam							
2008 ^a	148,951		6,867	155,818		31/3/2011	203p
2009 ^b	948,755		43,749		992,504	31/3/2012	128.41p
2010 ^c		707,546	32,626		740,172	31/3/2013	134.26p
G Patterson							
2008 ^b	702,612		32,398	735,010		31/3/2011	203p
2009 ^b	998,689		46,051		1,044,740	31/3/2012	128.41p
2010 ^c		744,786	34,343		779,129	31/3/2013	134.26p

^a Awards granted on 25 June 2008. The number of shares subject to awards was calculated using the average middle market price of a BT share for the three days prior to the grant. The awards would vest subject to meeting a performance condition, on 31 March 2011.

The performance measure was relative TSR compared with a group of 15 companies from the European Telecom Sector as at 1 April 2008. BT's TSR had to be in the upper quartile for all the shares to vest. At median, 25% of the shares would vest. Below that point, no shares would vest. At 31 March 2011, BT's TSR was at 9th position against the comparator group. As a result all of the awards lapsed on that date.

^b Awards granted on 7 August 2009. The number of shares subject to awards was calculated using the average middle market price of a BT share for the three days prior to the grant. 50% of each award of shares is linked to TSR compared with a group of 25 companies and 50% is linked to

a three-year cumulative free cash flow measure. The awards will vest subject to meeting the two performance conditions, on 31 March 2012.

^c Awards granted on 25 June 2010. The number of shares subject to awards was calculated using the average middle market price of a BT share for the three days prior to the grant. 50% of each award of shares is linked to TSR compared with a group of 25 companies and 50% is linked to a three-year cumulative free cash flow measure. The awards will vest subject to meeting two performance conditions, on 31 March 2013.

Vesting of outstanding awards of incentive shares

	Vesting date	31 March 2011				31 March 2010	
		Free cash flow position	Percentage of shares vesting	TSR position	Percentage of shares vesting	TSR position	Percentage of shares vesting
2007 ^a	31/3/2010	N/A	N/A	14	0%	14	0%
2008 ^b	31/3/2011	N/A	N/A	9	0%	14	0%

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2009 ^c	31/3/2012	100%	50%	4	50%	100%	50%	10	31%
2010 ^d	31/3/2013	100%	50%	2	50%	100%	50%		

^a The performance period for the 2007 awards ended on 31 March 2010. BT's TSR position was at 14th position against the European Telecom Sector of 15 companies. As a result, all the shares lapsed on that date.

^b The performance period for the 2008 awards ended on 31 March 2011. BT's TSR position was at 9th position against the European Telecom Sector of 15 companies. As a result all the shares lapsed on that date.

^c The performance period for the 2009 awards ends on 31 March 2012. 50% of each award of shares is linked to TSR; and 50% is linked to a three-year

cumulative free cash flow measure. (See Long-term share-based incentives on page 72). The awards will vest subject to meeting the two performance conditions on 31 March 2012.

^d The performance period for the 2010 awards ends on 31 March 2013. 50% of each award of shares is linked to TSR; and 50% is linked to a three-year cumulative free cash flow measure. (See Long-term share-based incentives on page 72). The awards will vest subject to meeting the two performance conditions on 31 March 2013.

Note: For awards granted in 2009 and 2010, the vesting level is the anticipated level based on performance to date.

REPORT OF THE DIRECTORS REPORT ON DIRECTORS REMUNERATION**Deferred share awards at 31 March 2011, or date of appointment, if later**

The following deferred share awards have been granted to the directors. These shares will normally be transferred to participants at the end of the three-year deferred period if those participants are still employed by BT Group.

	1 April 2010	Dividends re-invested	Total number of award shares 31 March 2011	Vesting date	Price at grant	Market price at vesting	Monetary value of award at vesting £000
I Livingston	142,312		142,312	1/8/2010	321.67p	142p	£ 202
	226,946	10,464	237,410	1/8/2011	203p		
	274,358	12,650	287,008	1/8/2012	128.41p		
	898,212	41,417	939,629	1/8/2013	134.26p		
T Chanmugam	38,422		38,422	1/8/2010	321.67p	142p	£55
	53,357	2,459	55,816	1/8/2011	203p		
	61,529	2,836	64,365	1/8/2012	128.41p		
	258,431	11,916	270,347	1/8/2013	134.26p		
G Patterson	58,931		58,931	1/8/2010	321.67p	142p	£84
	92,611	4,269	96,880	1/8/2011	203p		
	96,832	4,464	101,296	1/8/2012	128.41p		
	272,033	12,543	284,576	1/8/2013	134.26p		
Former Director							
H Lalani ^b	124,691		124,691	1/8/2010	321.67p	142p	£ 177
	105,374	4,858	110,232	1/8/2011	203p		

^a Awards granted on 25 June 2010 in respect of the 2010 financial year. The number of shares subject to awards was calculated using the average middle market price of a BT

share for the three days prior to the grant.

^b Hanif Lalani left the company on 31 March 2010. His award of 110,232 shares was pro-rated and will vest on 1 August 2011.

Details of awards of deferred shares in respect of the 2011 financial year are given in the table on page 77. The number of shares subject to the awards will be calculated using the average middle market price of a BT share for the three days prior to the grant. It is expected that awards will be granted in June 2011.

Share awards under the Employee Share Investment Plan (ESIP) at 31 March 2011, or at date of appointment, if later

	Total number of shares 31 March 2011
I Livingston	363
T Chanmugam	679
G Patterson	247

During the year no awards of shares were granted under the ESIP.

All UK employees may participate in the ESIP. The awards are not subject to any performance conditions.

By order of the Board

Rt Hon Patricia Hewitt

Chair of Remuneration Committee

11 May 2011

REPORT OF THE DIRECTORS

DIRECTORS INFORMATION

Election and re-election

All directors are required by BT's Articles of Association to be elected by shareholders at the first annual general meeting (AGM) after their appointment, if appointed by the Board. A director must subsequently retire by rotation at an AGM at intervals of not more than three years. The director may seek re-election.

Nich Rose and Jasmine Whitbread, having been appointed as directors by the Board, will retire at the 2011 AGM and will be proposed for election. In line with the New Code, the Board has decided that all other directors except Clay Brendish, will be proposed for re-election. Clay, whose appointment will end on 31 August 2011 will then retire from the Board. Details of these directors' contracts/letters of appointment are included in the **Report on directors remuneration**.

The chairman reviewed the performance of each director and found that each of them makes an effective contribution to the deliberations of the Board and continues to demonstrate commitment to the role. The Chairman's performance was reviewed by the senior independent director.

Meetings attendance

The following table shows the attendance of directors at meetings of the Board and *Audit & Risk, Nominating & Governance* and *Remuneration Committees* during the 2011 financial year.

	Board	Audit & Risk Committee	Nominating & Governance Committee	Remuneration Committee
	Number of meetings held			
	10	6	4	6
	Number of meetings attended (maximum possible)			
Sir Michael Rake ^a	9(10)		4(4)	1(1)
Ian Livingston	10(10)			
Tony Chanmugam	10(10)			
Gavin Patterson	10(10)			
Clay Brendish	9(10)	6(6)	4(4)	
Carl Symon	10(10)	6(6)		6(6)
Phil Hodgkinson	9(10)	6(6)	3(4)	
Patricia Hewitt	8(10)	6(6)	3(4)	6(6)
Eric Daniels	9(10)		4(4)	6(6)
Tony Ball	10(10)		4(4)	
Nick Rose ^b	2(2)			
Jasmine Whitbread ^c	2(2)			

^a Sir Michael Rake ceased to be a member of *Remuneration Committee* on 31 May 2010.

^b

Nick Rose was appointed to the Board on 1 January 2011.

^c Jasmine Whitbread was appointed to the Board on 19 January 2011.

The Board keeps under review the level of attendance, and contribution by directors at Board meetings and the Chairman meets with non-executive directors on an individual basis.

Service agreements

The Chairman and executive directors have service agreements, the terms of which are approved by the *Remuneration Committee*. Information about the periods of these contracts is in the **Report on directors remuneration**.

Training and information

On appointment, directors take part in an induction programme when they receive information about BT, the role of the Board and the matters reserved for its decision, the terms of reference and membership of the main Board committees, and the powers delegated to those committees, BT's corporate governance policies and procedures, including the powers reserved to the group's most senior executives, and the latest financial information. Since appointment in January 2011, Nick Rose and Jasmine Whitbread have met with the Operating Committee members. They have also had a series of meetings with other key senior executives across the company and in relation to committee memberships, specific briefings have taken place.

Directors are continually updated on BT's business, the competitive and regulatory environments in which it operates, technology and corporate responsibility matters and other changes affecting BT and the communications industry as a whole, by written briefings and meetings with senior BT executives. The Board has an annual strategy meeting, with regular reviews during the year. Directors are also advised on appointment of their legal and other duties and obligations as a director of a listed company, both in writing and in face-to-face meetings with the Company Secretary. They are reminded of certain obligations each year and they are also updated on changes to the legal, accounting and governance requirements affecting the company and themselves as directors. During the 2011 financial year, for example, the Board received briefings on changes to UK company law and on various corporate governance matters through regular Secretary's Reports. The Chairman also sends a weekly email to non-executive directors which includes topical sector highlights and updates on key business activities.

Guidelines govern the content, presentation and delivery of papers for each Board meeting, so that the directors have enough information to be properly briefed sufficiently far ahead of each Board meeting and at other appropriate times, and to take account of their duties as directors.

Independent advice

The Board has a procedure for directors, in carrying out their duties, to take independent professional advice if necessary, at BT's expense. All directors also have access to the advice and services of the Company Secretary.

Directors and officers liability insurance and indemnity

For some years, BT has purchased insurance to cover the directors and officers of BT Group plc and its subsidiaries (and the BT nominated directors of associated companies and joint ventures) against defence costs and civil damages awarded following an action brought against them in that capacity. The insurance operates to protect the directors and officers directly in circumstances where by law BT cannot provide an indemnity and also provides BT, subject to a retention, with cover against the cost of indemnifying a director or officer. One layer of the programme is ringed-fenced for the directors of BT Group plc. The cover has been extended to provide limited cover for civil fines and penalties. At the date on which this report was approved, and throughout the 2011 financial year, the company's wholly owned subsidiary, British Telecommunications plc, has provided an indemnity in respect of a similar group of people who would be covered by the above insurance. Neither the insurance nor the indemnity provides cover where the person has acted fraudulently or dishonestly.

Interest of management in certain transactions

During and at the end of the 2011 financial year, none of BT's directors was materially interested in any material transaction in relation to the group's business and none is materially interested in any presently proposed material transactions.

REPORT OF THE DIRECTORS BUSINESS POLICIES

Responsible business

Our Statement of Business Practice: *The Way We Work* (TWWW) has been in place for more than 10 years. This covers all our operations and applies worldwide to all employees, and to all agents and contractors when representing BT, and is available in 11 languages. It is supported by a number of ethical policies, including Anti-Corruption and Bribery, Gifts and Hospitality and Charitable Donations and Sponsorship; as well as guidance on ethical issues. All employees and contractors are required to sign up to TWWW and our Anti-Corruption and Bribery Policy. Our suppliers are also expected to comply with the principles set out in TWWW and our ethical policies.

We operate a Gifts and Hospitality recording system for our employees to register and approve all gifts and business entertainment given and received. We are committed to high ethical standards and legal compliance in all aspects of our business. We have measured our employee awareness of TWWW and the extent to which our employees display ethical behaviour; and our performance measures on ethics track our policies. We have also conducted an independent culture survey to assess ethical behaviours within our business and to help us to build on our global culture for the coming year.

Through our Sourcing with Human Dignity initiative, we seek to ensure that working conditions throughout our supply chain meet internationally recognised human rights standards. We investigate potential social and environmental shortcomings and are committed to achieving 100% follow-up within three months for all suppliers identified as high or medium risk. During 2011, we completed 34 on-site assessments (2010: 32). The majority of assessments were conducted in China as well as in Vietnam, Turkey, Sri Lanka, the UK, Ukraine and Spain. We now employ our own assessor based in Shanghai, which has enabled us to focus our efforts on suppliers in China. We work with our suppliers to help them improve their performance. In 2011, 86% of our suppliers agreed that we work with them to ensure our purchases are made, delivered, used and disposed of in a socially and environmentally responsible manner.

The principles in TWWW and our ethical policies are supported by a continuing and comprehensive communication programme and training. A dedicated ethics helpdesk is available to employees who have questions or would like guidance about our ethical policies. We also provide a confidential helpline so people can report any ethical concerns. BT's Undertakings code of practice (*It matters*) forms part of our statement of business practice and is consistent with it.

We are committed to managing our environmental performance. BT's environmental management system within the UK has been certified to the international standard ISO 14001 since 1999. Since then we have extended our main certification to include Belgium, Ireland, Germany and the Netherlands. BT Italy and BT Spain hold their own individual ISO 14001 certifications.

A Board committee – the *Committee for Sustainable & Responsible Business* – chaired by Sir Michael Rake and comprising three BT senior executives, three non-executive directors and three independent members – oversees our corporate responsibility, environment and community activities, including charitable expenditure and the strategy for maximising our contribution to society. More information is available in **Business review – Our corporate responsibility** on page 36. The **Report of the Committee for Sustainable & Responsible Business** is on page 68.

Political donations

Our continuing policy is that no company in the group will make contributions in cash or kind to any political party, whether by gift or loan. However, the definition of political donations used in the Companies Act 2006 (the 2006 Act) is very much broader than the sense in which these words are ordinarily used. It may cover activities such as making MPs and others in the political world aware of key industry issues and matters affecting the company, which make an important contribution to their understanding of BT. These activities have been carried out on an even-handed basis, related broadly to the major UK political parties' electoral strength. The authority we are requesting at the AGM is not designed to change the above policy. It will, however, ensure that BT continues to act within the provisions of the 2006 Act requiring companies to obtain shareholder authority before they can make donations to EU political parties and/or political organisations as defined in the 2006 Act. During 2011, the company's wholly-owned subsidiary, British Telecommunications plc, made the following payments totalling £11,935 (2010: £14,952) to cover, for

example, the cost of hosting briefing meetings with MPs and MEPs about the company's activities: Labour Party £2,000; Conservative Party £3,686; Liberal Democrats £600; Scottish National Party £4,650 and Plaid Cymru £999. No loans were made to any political party by any company in the BT group.

Pension funds

BT's two main UK pension arrangements – the BT Pension Scheme (BTPS) and the BT Retirement Saving Scheme (BTRSS) – are not controlled by the Board but by a separate and independent corporate trustee for the BTPS and a management committee for the BTRSS. The Trustee of the BTPS looks after the assets of the funds, which are held separately from those of the company. For BTRSS members, each member has an individual personal pension secured with an insurance company (Standard Life). Pension funds' assets can be used only in accordance with their respective rules and for no other purpose. More information on the BTPS is included in note 23 to the consolidated financial statements.

Financial statements

So far as each of the directors is aware, there is no relevant information that has not been disclosed to the auditors and each of the directors believes that all steps have been taken that ought to have been taken to make them aware of any relevant audit information and to establish that the auditors have been made aware of that information.

A statement by the directors of their responsibilities for preparing the financial statements is included in the

Statement of directors' responsibility on page 88. The directors' statement on going concern is included in the **Financial review** on page 54.

Takeover Directive disclosure

Following the implementation of the EU Takeover Directive by certain provisions of the 2006 Act, we are required to make additional disclosures. A number of these disclosures can be found elsewhere in this Report as set out below:

- structure of BT's share capital (refer to page 137) including the rights and obligations attaching to the shares (refer to pages 167 to 170)

- restrictions on the transfer of BT shares and voting rights (refer to pages 167 and 168)

- significant direct or indirect shareholdings (refer to page 86)

- appointment and replacement of directors (refer to page 169).

REPORT OF THE DIRECTORS BUSINESS POLICIES

The disclosures which are not covered elsewhere in this Report include the following:

BT has two employee share ownership trusts which hold BT shares for the purpose of satisfying awards made under the various employee share plans. The trustee of the BT Group Employee Share Investment Plan may invite participants on whose behalf it holds shares to direct it how to vote in respect of those shares, and if there is an offer for the shares or other transaction which would lead to a change of control of BT, participants may direct it to accept the offer or agree to the transaction. In respect of shares held in the BT Group Employee Share Ownership Trust, the trustee abstains from voting those shares, and if there is an offer for the shares the trustee is not obliged to accept or reject the offer but will have regard to the interests of the participants, may consult them to obtain their views on the offer and may otherwise take the action with respect to the offer it thinks fair

we are not aware of any agreements between shareholders that may result in restrictions on the transfer of shares or on voting rights

no person holds securities carrying special rights with regard to control of the company

proxy appointment and voting instructions must be received by the registrars not less than 48 hours before a general meeting (see also page 167)

the amendment of BT's Articles of Association requires shareholder approval in accordance with legislation in force from time to time

the powers of the directors are determined by UK legislation and the Articles of Association. They are authorised to issue and allot shares, and to undertake purchases of BT shares subject to shareholder approval at the AGM

BT Group plc is not party to any significant agreements that take effect, alter or terminate upon a change of control following a takeover

we do not have any agreements with directors providing for compensation for loss of office or employment that occurs because of a takeover. There is similarly no such provision in standard contracts for employees.

Financial instruments

Details of the financial risk management objectives and policies of the group and exposure to interest risk, credit risk, liquidity risk and foreign exchange are given in note 29 on pages 139 to 149.

Internal control and risk management

The Board is responsible for the group's systems of internal control and risk management and for reviewing each year the effectiveness of those systems. Such systems are designed to manage, rather than eliminate, the risk of failure to achieve business objectives; any system can provide only reasonable, and not absolute, assurance against material misstatement or loss. The process in place for reviewing BT's systems of internal control includes procedures designed to identify and evaluate failings and weaknesses, and, in the case of any categorised as significant, procedures exist to ensure that necessary action is taken to remedy the failings.

The Board also takes account of significant social, environmental and ethical matters that relate to BT's businesses and reviews annually BT's corporate responsibility policy. The company's workplace practices, specific environmental, social and ethical risks and opportunities and details of underlying governance processes are dealt with in the

Business review Our resources on page 19.

We have enterprise-wide risk management processes for identifying, evaluating and managing the significant risks faced by the group. These processes have been in place for the whole of the 2011 financial year and have continued up to the date on which this document was approved. The processes are in accordance with the Revised Guidance for Directors on the Combined Code published by the Financial Reporting Council (the Turnbull Guidance).

Risk assessment and evaluation takes place as an integral part of BT's annual strategic planning cycle. We have a detailed risk management process, culminating in a Board review, which identifies the key risks facing the group and each business unit. This information is reviewed by senior management as part of the strategic review. Our current key risks are summarised in **Business review – Our risks** on pages 40 and 43.

The key features of the enterprise-wide risk management and internal control process comprise the following procedures:

- senior executives collectively review the group's key risks and have created a group risk register describing the risks, owners and mitigation strategies. This is reviewed by the *Operating Committee* before being reviewed and approved by the Board

- the lines of business and internal service units carry out risk assessments of their operations, create risk registers relating to those operations, and ensure that the key risks are addressed

- senior executives with responsibilities for major group operations report quarterly with their opinion on the effectiveness of the operation of internal controls in their area of responsibility

- the group's internal auditors carry out continuing assessments of the quality of risk management and control, report to management and the *Audit & Risk Committee* on the status of specific areas identified for improvement and promote effective risk management in the lines of business and internal service units operations

- the *Audit & Risk Committee*, on behalf of the Board, considers the effectiveness of the operation of internal control procedures in the group during the financial year. It reviews reports from the internal and external auditors and reports its conclusions to the Board. The *Audit & Risk Committee* has carried out these actions for the 2011 financial year.

Joint ventures and associates, which BT does not control, have not been dealt with as part of the group risk management process and are responsible for their own internal control assessment.

BT's accounting policies are set out on pages 91 to 99. The consistent application of those policies is subject to ongoing verification through management review and by independent review by internal and external auditors. The processes supporting the preparation and consolidation of the financial statements have been documented and are subject to annual verification through the programme of testing conducted jointly by our internal and external auditors which serves to confirm the operation of the internal controls over financial reporting and compliance with the Sarbanes-Oxley Act. The *Audit & Risk Committee* reviews BT's published financial results, related disclosures and accounting judgments – the Committee's activities are set out on pages 65 to 66.

The Board has approved the formal statement of matters which are reserved to it for consideration, approval or oversight. It has also approved the group's corporate governance framework, which sets out the high level principles by which BT is managed and the responsibilities and powers of the *Operating Committee* and the group's senior executives. As part of this framework, the development and implementation of certain powers relating to group-wide policies and practices are reserved to identified senior executives.

REPORT OF THE DIRECTORS BUSINESS POLICIES

US Sarbanes-Oxley Act of 2002

BT has securities registered with the US Securities and Exchange Commission (SEC). As a result, we must comply with those provisions of the Sarbanes-Oxley Act applicable to foreign issuers. We comply with the legal and regulatory requirements introduced pursuant to this legislation, in so far as they are applicable.

The *Audit & Risk Committee* includes members Phil Hodgkinson and Nick Rose who, in the opinion of the Board, are audit committee financial experts and who are independent (as defined for this purpose). The Board considers that the Committee's members have broad commercial knowledge and extensive business leadership experience, having held between them various prior roles in major business, Government, financial management, treasury and financial function supervision and that this constitutes a broad and suitable mix of business and financial experience on the Committee. The code of ethics adopted for the purposes of the Sarbanes-Oxley Act is posted on the company's website at www.bt.com/ethics. The code applies to the Chief Executive, Group Finance Director and senior finance managers.

Disclosure controls and procedures

The Chief Executive and Group Finance Director, after evaluating the effectiveness of BT's disclosure controls and procedures as of the end of the period covered by this Annual Report & Form 20-F, have concluded that, as of such date, BT's disclosure controls and procedures were effective to ensure that material information relating to BT was made known to them by others within the group.

The Chief Executive and Group Finance Director concluded that BT's disclosure controls and procedures are also effective to ensure that the information required to be disclosed by the company in reports that it files under the Exchange Act is recorded, processed, summarised and reported within the time periods specified in the rules and forms of the SEC.

The Chief Executive and Group Finance Director have also provided the certifications required by the Sarbanes-Oxley Act.

Internal control over financial reporting

BT's management is responsible for establishing and maintaining adequate internal control over financial reporting for the group including the consolidation process. Internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external reporting purposes in accordance with IFRS. Management conducted an assessment of the effectiveness of internal control over financial reporting based on the framework for internal control evaluation contained in the Turnbull Guidance.

Based on this assessment, management has concluded that as at 31 March 2011, BT's internal control over financial reporting was effective.

There were no changes in BT's internal control over financial reporting that occurred during 2011 that have materially affected, or are reasonably likely to have materially affected, the group's internal control over financial reporting. Any significant deficiency, as defined by the US Public Company Accounting Oversight Board (PCAOB), in internal control over financial reporting, is reported to the *Audit & Risk Committee*. PricewaterhouseCoopers LLP, which has audited the consolidated financial statements for 2011, has also audited the effectiveness of the group's internal control over financial reporting under Auditing Standard No.5 of the PCAOB. Their report is on page 90.

REPORT OF THE DIRECTORS SHAREHOLDERS AND ANNUAL GENERAL MEETING

Relations with shareholders

Senior executives, led by the Chief Executive and the Group Finance Director and including, as appropriate, the other executive directors, hold meetings with BT's institutional shareholders and prospective shareholders to discuss BT's strategy, financial performance and prospects. The Chairman also meets with major shareholders, at their request, during the year. This may also include meetings to discuss remuneration policies and governance issues. All non-executive directors have an invitation to attend investor meetings if they wish and during the year the Senior Independent Director has held meetings with major institutional shareholders and representative bodies about governance and remuneration policy. Contact with institutional shareholders (and with financial analysts, brokers and the media) is controlled by written guidelines to ensure the protection of inside information that has not already been made generally available to the market. The directors are provided with reports and other written briefings on shareholders' and analysts' views and are regularly informed by the Company Secretary about the holdings of the principal shareholders. The Company Secretary also surveys private shareholders about the quality of our shareholder communications. In 2010 we randomly selected 9,000 private shareholders to give them an opportunity to provide feedback and help us improve our engagement with them. In line with our cost transformation objectives we are encouraging our private shareholders to receive electronic shareholder communications.

Established procedures ensure the timely release of inside information and the publication of financial results and regulatory financial statements. All external announcements are also reviewed for accuracy and compliance requirements by a committee of senior executives, the Disclosure Committee, which is chaired by the Company Secretary.

Substantial shareholdings

At 6 May 2011 BT had received notifications, under the Disclosure and Transparency Rules issued by the Financial Services Authority, in respect of the following holdings of shares representing percentage holdings of BT's total voting rights as shown:

	Shares	% of total voting rights
Invesco Limited	845,250,432	10.88
BlackRock Inc.	398,607,977	5.14

AGM resolutions

Shareholders will be asked to vote on the annual report at the AGM. Shareholders will also again be asked to vote separately on the **Report on directors' remuneration**.

It is part of our policy to involve shareholders fully in the affairs of the company and to give them the opportunity at the AGM to ask questions about BT's activities and prospects. We also give shareholders the opportunity to vote on every substantially different issue by proposing a separate resolution for each issue. The proxy votes for and against each resolution, as well as votes withheld, will be counted before the AGM and the results will be made available at the meeting. As at the 2010 AGM, votes on all matters at the 2011 AGM, except procedural issues, will be taken on a poll. Every vote cast, whether in person or by proxy at the meeting will be counted. The outcome of voting on the resolutions will be posted on our website as soon as possible after the meeting. It is our policy for all directors to attend the AGM if at all possible. Whilst, because of ill health or other pressing reasons, this may not always be possible, in normal circumstances this means that the chairs of the *Audit & Risk, Nominating & Governance* and *Remuneration* Committees are at the AGM and are available to answer relevant questions. All the directors attended the 2010 AGM.

The resolutions to be proposed at the 2011 AGM at Old Billingsgate, London on 13 July, together with explanatory notes, appear in the separate *Summary financial statement & notice of meeting 2011* which is sent to all shareholders

who have requested a copy. Copies of this annual report are sent only to shareholders who have requested or request a copy. All shareholders are notified of the publication of these documents which are sent out in the most cost-effective way. We aim to give as much notice of our AGM as possible and at least 21 clear days' notice, as required by our Articles of Association. In practice, these documents are being sent to shareholders more than 20 working days before the AGM.

Resolutions to re-appoint PricewaterhouseCoopers LLP as BT's auditors and to authorise the directors to agree their remuneration will also be proposed at the AGM.

The presentation made by the Chairman and the Chief Executive will be broadcast live on the internet at www.bt.com/btagm2011 and will be available after the AGM.

Authority to purchase shares

The authority given at last year's AGM of the company held on 22 July 2010 for BT to purchase in the market 775m of its shares, representing 10% of the issued share capital, expires on 13 July 2011. Shareholders will be asked to give a similar authority at the AGM.

During 2011, 9.7m treasury shares were transferred to meet BT's obligations under our employee share plans. At 6 May 2011 a total of 389m shares were retained as treasury shares. All the shares were purchased in an on-market programme of buying back BT shares, started in November 2003. The programme was suspended with effect from 31 July 2008.

By order of the Board

Andrew Parker

Company Secretary

11 May 2011

STATEMENT OF DIRECTORS RESPONSIBILITIES

REPORT OF THE INDEPENDENT AUDITORS CONSOLIDATED FINANCIAL STATEMENTS

United Kingdom opinion

United States opinion

CONSOLIDATED FINANCIAL STATEMENTS

ACCOUNTING POLICIES

GROUP INCOME STATEMENT

GROUP STATEMENT OF COMPREHENSIVE INCOME

GROUP STATEMENT OF CHANGES IN EQUITY

GROUP CASH FLOW STATEMENT

GROUP BALANCE SHEET

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

1. Segment information
2. Other operating income
3. Operating costs
4. Employees
5. Related party transactions
6. Share-based payments
7. Audit and non-audit services
8. Specific items
9. Finance expense and finance income
10. Taxation
11. Earnings (loss) per share
12. Dividends
13. Intangible assets

14. Property, plant and equipment
15. Investments
16. Cash and cash equivalents
17. Associates and joint ventures
18. Inventories
19. Trade and other receivables
20. Loans and other borrowings
21. Derivative financial instruments
22. Trade and other payables
23. Retirement benefit plans
24. Deferred taxation
25. Provisions
26. Non-controlling interests
27. Share capital
28. Other reserves
29. Financial instruments and risk management
30. Financial commitments and contingent liabilities

REPORT OF THE INDEPENDENT AUDITORS - PARENT COMPANY FINANCIAL STATEMENTS

FINANCIAL STATEMENTS OF BT GROUP PLC

SUBSIDIARY UNDERTAKINGS AND ASSOCIATE

FINANCIAL STATEMENTS

STATEMENT OF DIRECTORS' RESPONSIBILITIES

The directors are responsible for preparing the Annual Report, the Report on directors' remuneration and the financial statements in accordance with applicable law and regulations.

Company law requires the directors to prepare financial statements for each financial year. Under that law the directors have elected to prepare the consolidated financial statements in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union, and the parent company financial statements in accordance with United Kingdom Generally Accepted Accounting Practice (United Kingdom Accounting Standards and applicable law). In preparing the consolidated financial statements, the directors have also elected to comply with IFRSs, issued by the International Accounting Standards Board (IASB). Under company law the directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the group and the company and of the profit or loss of the group for that period. In preparing these financial statements, the directors are required to:

- select suitable accounting policies and then apply them consistently;

- make judgments and accounting estimates that are reasonable and pru