BT GROUP PLC
Form 6-K
May 27, 2009

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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, 2009
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 X Form 40-F o

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 o No X

Enclosure: BT Group plc Annual Report and Form 20-F 2009 as sent to shareholders

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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/ Alan Scott
Name:	Alan Scott
Title:	Deputy Secretary

Date: May 27, 2009

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BT GROUP PLC ANNUAL REPORT & FORM 20-F

BT GROUP PLC ANNUAL REPORT & FORM 20-F

BT Group plc
Annual Report
& Form 20-F
2009

BT Group plc is a public limited company registered in England and Wales and listed on the London and New York stock exchanges. It was incorporated in England and Wales on 30 March 2001 as Newgate Telecommunications Limited with the registered number 4190816. Its registered office address is 81 Newgate Street, London EC1A 7AJ. The company changed its name to BT Group plc on 11 September 2001. Following the demerger of O2 in November 2001, the continuing activities of BT were transferred to BT Group plc.

British Telecommunications plc is a wholly owned subsidiary of BT Group plc and encompasses virtually all the businesses and assets of the BT group. The successor to the statutory corporation British Telecommunications, it was incorporated in England and Wales as a public limited company, wholly owned by the UK Government, as a result of the Telecommunications Act 1984. Between November 1984 and July 1993, the UK Government sold all of its shareholding in British Telecommunications plc in three public offerings.

This is the Annual Report for the year ended 31 March 2009. It complies with UK regulations and is 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 2009 has been issued to all shareholders.

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

References to a year are to the financial year ended 31 March of that year, eg 2009 refers to the year ended 31 March 2009. Unless otherwise stated, all non-financial statistics are at 31 March 2009. Please see cautionary statement regarding forward-looking statements on page 148.

A number of measures quoted in this Annual Report are non-GAAP measures. The Directors believe these measures provide a more meaningful analysis of the trading results of the group and are consistent with the way financial performance is measured by management. These include EBITDA, adjusted EBITDA, adjusted operating profit, adjusted profit before taxation, adjusted earnings per share, net debt and free cash flow. The rationale for using non-GAAP measures and reconciliations to the most directly comparable IFRS indicator are provided on pages 33 to 35, 39, 41, 47 and 48.

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FINANCIAL SUMMARY

	2009 £m	2008 £m
Revenue	**£21,390**	£20,704
EBITDA[a]		
adjusted[b,c]	**£5,348**	£5,784
reported	**£3,301**	£5,245
Profit (loss) before taxation		
adjusted[b,c]	**£1,877**	£2,506
reported	**£(134)**	£1,976
Earnings (loss) per share		
adjusted[b,c]	**18.4p**	23.9p
reported	**(1.1)p**	21.5p
Full year proposed dividend	**6.5p**	15.8p

Key performance indicators

Key points

4 Revenue growth of 3%

4 EBITDA decline due to the unacceptable performance of BT Global Services

4 The rest of the business delivered a good performance in spite of the economic downturn

4 BT Global Services contract and financial review charges of £1.6bn and a specific item restructuring charge of £280m

4 Pension deficit payments of £525m per annum for the next three years

4 Full year proposed dividend of 6.5p per share

[a] EBITDA: Earnings before interest, taxation, depreciation and amortisation.

[b] Items presented as adjusted are stated before contract and financial review charges recorded within BT Global Services and specific items.

[c] Adjusted EBITDA, adjusted profit before taxation, adjusted earnings per share and free cash flow are non-GAAP measures. The rationale for using non-GAAP measures and reconciliations to the most directly comparable IFRS indicators are provided in the Financial review on pages 33-35, 39, 41, 47 and 48.

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OVERVIEW
CHAIRMAN S MESSAGE

The world looks a very different place than it did a year ago. Global trade has contracted for the first time in many decades. Financial markets have been in turmoil and trading conditions worldwide remain extremely challenging. Against this background, the importance of defending free trade and fighting for regulation that promotes investment and encourages competition has never been greater.

Our management team not only understands the challenges, but also sees the opportunities that lie ahead. Three out of our four principal divisions (BT Retail, BT Wholesale and Openreach) are delivering well. Management s highest attention is now directed towards returning BT Global Services, our one under performing division, to profitable growth.

We have agreed with the Trustee of the BT Pension Scheme the pension contributions for the next three years, enabling the Board to announce a sustainable dividend policy.

The proposed final dividend of 1.1p gives a full year dividend of 6.5p which rebases dividend payments to a level which we are confident is sustainable. The Board is committed to delivering attractive returns for shareholders and believes that the operational improvements in the business will generate sufficient cash flow to allow the dividend to grow at the same time as investing in the business, reducing debt and supporting the pension scheme.

Regulation

It is clear how important the 2005 Telecommunications Strategic Review by Ofcom has been in establishing the UK as the most competitive telecommunications market in the world. While the price of other utilities has soared, the price of communications has fallen sharply. New market entrants have flourished, encouraged by low wholesale prices and incentives to invest in unbundled local loops. Britain has more companies competing in the same space than any comparator country.

Now a healthy debate is underway about the investment needed to deliver the next generation of broadband services. These will be carried largely over fibre optic cables able to deliver speeds of up to 100Mb compared with a typical speed of 4-5Mb today. This investment will provide the UK with the world class IT infrastructure it will need to thrive as a knowledge-based society.

It is essential that the regulatory environment encourages investment. This means that BT and others must have the potential to make a return for shareholders that is commensurate with the risk involved. We need a level playing field in the UK s fast moving market which allows every company to compete on equal terms and makes sure that new monopolies are not allowed to emerge. We also need regulation to move at the same speed as the market is evolving.

In our overseas markets, particularly in the rest of Europe and in North America, regulators must do more to encourage fair competition. BT should be able to invest and compete in any other country, in the same unrestricted manner that overseas companies can invest and compete in the UK.

A sustainable business

BT has a proud record of contributing to the communities in which we work and of building a sustainable business. We believe our services are an important part of the solution to climate change.

Thousands of our people are involved in voluntary work and I am keen to build on this heritage and make sure that as a global business BT s Better World Campaign takes a genuinely global view.

Your Board

In December 2008, we welcomed Tony Chanmugam to the Board as Group Finance Director in succession to Hanif Lalani who had become Chief Executive, BT Global Services.

Since joining BT I have been extremely fortunate to have as my Deputy Chairman, Maarten van den Bergh who is stepping down from the Board at the conclusion of this year s AGM in July. Maarten has been a tremendous asset to the Board having served as senior independent director since 2006 and as Chairman of both the Board s Pension Scheme Performance Review Group and Remuneration Committee. I would like to thank him for almost nine years of distinguished service.

I would also like to express my gratitude to Matti Alahuhta who has decided to step down at the end of May having served as a non executive director for just over three years. His telecommunications industry and international experience have been of great value to the Board and we wish him well.

I am working with the Nominating Committee to strengthen your Board following these departures and we will announce new appointments shortly.

My thanks also go to the rest of the Board for their extremely hard work during the last challenging months. I would also like to pay tribute to the BT staff. Everywhere I go I have been struck by their passion and commitment. I am confident in their ability to build on BT s many strengths in the future.

The future

BT is in business for the long-term. We invest billions of pounds into the UK s IT infrastructure for the long-term. We are seeking the regulatory certainty which will support long-term business decisions. And we want long-term relationships with our customers that are based on excellent service, and on our enduring commitment to helping them thrive in this fast changing world.

Sir Michael Rake
Chairman
13 May 2009

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OVERVIEW
CHIEF EXECUTIVE S STATEMENT

The actions we have taken will enable BT to come out of this recession a stronger and better business.

There s no doubt about it, this has been a tough year. A tough year for BT Group, a tough year for the economy and a tough year for our shareholders.

But there are good reasons to look forward with optimism. Taken together, BT Retail, BT Wholesale and Openreach have delivered a resilient performance. That despite the economic downturn. However this success was overshadowed by the performance at BT Global Services. Because of this we have had to take a number of very substantial charges. These have not been comfortable, but were necessary to establish the solid foundations from which we can now build a profitable business.

Meeting our customers needs

The markets in which we operate are changing fast and we need to move with them. In the UK we have the most competitive communications market in the world. Thanks largely to BT s investment, the UK now has some of the highest broadband availability and take up in the world as well as some of the lowest prices. Speeds are improving all the time, and our new fibre based services will deliver a next generation of super-fast broadband, bringing speeds of up to 100Mb to people s homes.

We have made real improvements in customer service, and we are going to do much more. Let me give you a couple of examples. Three years ago you could expect a fault on your telephone line once every nine years. That s now improved to once every 13 years. By the end of the financial year, 97% of our customers were getting through on their first call, complaints were down and customer satisfaction had improved significantly. And on Christmas Day 2008 we recorded our lowest ever number of outstanding network faults.

When our service improves, our customers are happy, more people want to do business with us, and also we can reduce our costs. That s because when we get our services right first time, the number of people phoning our call centres falls and the number of engineers we need to send out to fix things declines. That s just as true for the biggest customer of BT Global Services or BT Wholesale as it is for a family buying a broadband service from us. We have made significant progress, but this is most definitely not the end of our journey to make BT a leader in customer service.

New opportunities

Even in the most difficult economic circumstances a diverse and agile business will find opportunities to grow and improve the service it delivers to its customers. A really good example is BT Conferencing which is strongly growing both revenues and profits and is now the world s biggest provider of videoconferencing. Using the latest technology we are meeting the needs of companies all around the world. Helping customers save money by cutting travel costs and reducing their carbon footprint.

Another example is our Business One Plan service, which is the UK s first triple play of landline, mobile and broadband for small and medium-sized businesses. It launched three years ago and in 2009 added free calls within an organisation even between offices and mobile workers a significant saving. Over a million business lines are now using this service and more than 2,500 new customers sign up each week. In our consumer business the new BT Home Hub has been ordered by over 800,000 customers since its launch last June. It has the best wireless range on offer, and allows customers to save power by programming it to switch off when it s not being used.

These are just a few examples of BT seizing opportunities and delivering great service in the UK and around the globe. I was particularly pleased that Telemark Services, an industry analyst, has just rated BT Global Services the best operator in the world in its Customer Satisfaction Index with the highest score ever awarded.

A better business, a better future

In order to transform the company, we need to drive significant cost saving. Regretfully this has meant a reduction in our workforce. However, we have sought to retrain and redeploy permanent staff whenever we can. That has meant that in the past year only a third of the reduction came from our permanent staff, with the rest made up of contractors and third-party resource.

So in the past year we have taken some tough decisions and we have taken some bold decisions too. Like investing £1.5bn in fibre based super-fast broadband. There are certainly plenty of challenges, but I believe that the actions we have taken will enable BT to come out of this recession a stronger and better business.

Ian Livingston
Chief Executive
13 May 2009

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OVERVIEW
THIS IS BT

BT is one of the world s leading communications services companies. In the UK, we are the largest communications service provider to the residential and business markets. The BT brand is one of the most trusted in the UK. Around the world, we are a major supplier of networked IT services to government departments and multinational companies.

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OVERVIEW
HOW WE ARE STRUCTURED

We meet the needs of our different customer groups through four customer-facing lines of business, supported by two internal functional units. BT Retail, BT Wholesale and Openreach operate mainly in the UK. BT Global Services provides services in more than 170 countries around the world.

We believe that the way we are structured brings us closer to our customers, helps us get it right first time and enhances the customer experience, at the same time as helping us reduce our costs and drive value for our shareholders.

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BUSINESS AND FINANCIAL REVIEWS

BUSINESS REVIEW

Falling prices, rising data speeds and constant innovation continue to make the communications marketplace dynamic and intensely competitive. In 2009, we faced the additional challenges of the economic downturn and an unacceptable performance from BT Global Services.

Introduction

BT is a communications services company which operates in more than 170 countries worldwide. We are proud to serve customers that range from some of the largest multinational corporations and public sector organisations in the world, through the small business sector to millions of families and residential customers in the UK.

We are at the heart of a communications revolution which is continuing to improve the quality of people s lives and the effectiveness of their businesses. It is our job to bring together the best technology to create services that our customers need while offering them the very best value.

Our 2009 performance

In 2009, in spite of the economic downturn, three of our lines of business BT Retail, BT Wholesale and Openreach have each performed well. Both BT Retail and Openreach delivered EBITDA growth while in BT Wholesale the rate of decline in revenue has slowed. This good performance was primarily due to the effective delivery of cost savings. However, these achievements were overshadowed by the unacceptable performance in BT Global Services.

The issues in BT Global Services

During the 2009 financial year, the level of profitability in BT Global Services fell significantly. This was caused by a combination of higher costs, the slow delivery of cost reduction initiatives and worsening economic conditions. This led the Board to conclude that previous estimates of profitability for some of our major contracts were no longer likely to be achieved.

On page 10 we explain what actions the Board took as a result of these issues and how BT Global Services is being restructured to streamline and refocus the business.

Our focus

We aim to make BT a better business and drive shareholder value by delivering on our current strategic priorities better, faster and cheaper.

These are:

- providing excellent customer service
- building future networks
- becoming more agile.

Providing excellent customer service

Our goal is to provide excellent service in every market in which we operate by putting our customers at the heart of everything we do.

Every part of BT is taking action to make substantial improvements to the delivery of our services. That means getting things right first time every time, keeping our promises to our customers and meeting or exceeding their expectations.

We continually track improvements that reflect the real experience of our customers from start to finish. We have made significant progress in the last 12 months across the whole range of our customers and we are determined to make further improvements. In the highly competitive markets in which we operate we believe that being recognised for outstanding customer service is a key differentiator for BT.

As an example of the progress we are making in the consumer market, the time taken to get through to an adviser fell by 65% in the past year. Our customers experienced a reduction of more than 20% in the number of line faults, which means that a line will go wrong on average just once every 13 years. In the small business market, there was a 20% improvement in the average time to clear telephony network faults, while the average time to provide international multi-protocol label switching (MPLS) services to large business customers reduced by over 40%.

Building future networks

The digital revolution is opening up a world of new possibilities for all our customers. It means people can work together and collaborate more effectively than ever before. They can be entertained and informed in ways that would have been hard to imagine just a few years ago. We think this revolution has only just begun, and we are investing in our networks, systems and services to ensure that they are fit for the future.

In July 2008, we announced plans to make Britain s biggest ever investment in a fibre-based super-fast broadband network. We will spend £1.5bn making fibre based services available to around 40% of the UK s homes and businesses by 2012. This will deliver a range of services with top speeds of up to 100Mb, allowing customers simultaneously to run multiple bandwidth-hungry applications, such as high-definition movies, gaming, complex graphics and videos; all with greatly improved upload as well as download speeds.

These plans are conditional on our ability to make a proper return on our investment, and we have seen encouraging progress in establishing the right regulatory basis for this investment.

Super-fast broadband will run on BT s 21CN infrastructure. 21CN is our next generation global platform and has been at the heart of BT s transformation for some years.

We have now completed the new 21CN core network which is a unified software driven platform. It will help us meet our customers needs faster and more efficiently whether they are delivered over copper or fibre. It will reduce the time it takes to get new services to market, eliminating duplication and reducing costs.

Our flagship MPLS network service provides coverage and support around the world from 875 BT managed points of presence and around 2,600 in partnership.

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Becoming more agile

Our goal is to combine the strengths of being a large company with the speed and flexibility of a small company. Our people are becoming more agile in the way they work together to serve customers. We are making our company more agile as well, cutting out any bureaucracy that can slow us down. As a result we will be more responsive to customer needs.

We are continuing to simplify our business to give people more authority and to allow them to do their jobs more effectively.

As we become a more agile organisation, we reduce our costs as well as the number of people we need to employ. In the past year we have reduced the number of full-time employees by around 5,000. In addition to this, the number of indirect employees working through agencies or third party contractors was reduced by around 10,000, giving a reduction in our total labour resource of some 15,000. We expect further reductions of a similar level in 2010. We have sought to retain our permanent workforce through redeployment and retraining, and will continue to do so. We continue our drive to reduce costs across the business, and made further progress in 2009 towards transforming our cost base.

Three out of four of our lines of business have made a strong contribution towards the delivery of cost savings, although BT Global Services still has to control costs more tightly and deliver greater savings.

Maintaining a sustainable business

BT is committed to contributing positively to the communities in which it works and to operating in a socially responsible way. We are using communications technology to help create a better, more sustainable world. Our goal is to help meet the challenge of climate change, to promote a more inclusive society and to enable sustainable economic growth.

We believe that being a recognised leader in the field of corporate responsibility contributes to shareholder value. It builds our brand and is central to the way we do business. It encourages the best people to want to work for BT. It is a powerful reason for customers to do business with us and stay loyal to us.

We commit a minimum of 1% of our pre-tax profits to activities that support society. We invested a total of £25m, comprising time, cash and in-kind contributions, in the community in 2009. Of this amount, £2.3m was in the form of charitable donations.

Measuring our performance

For 2009, the key performance indicators (KPI) against which we measured the delivery of our strategy were:

4 customer service

4 earnings per share

4 free cash flow.

Our customer service results were encouraging and we delivered significant improvements during the year. However, the unacceptable performance in BT Global Services impacted free cash flow and earnings per share, which were well below target.

Customer service

We set ourselves a group-wide stretching target in 2009 of improving right first time by 24%. We achieved an increase of 17%, compared with 9% in 2008 and we are targeting further improvements in 2010. We are now delivering excellent customer service levels in many areas.

Earnings per share

Adjusted basic earnings per share[a,b] were 18.4p in 2009, compared with 23.9p in 2008 and 22.7p in 2007 (see **Financial review** page 39). The reported basic loss per share was 1.1p in 2009, compared with basic earnings per share of 21.5p and 34.4p in 2008 and 2007, respectively.

Free cash flow

Free cash flow[b] in 2009 was £737m, compared with £1,503m in 2008 and £1,354m in 2007 (see **Financial review** page 41).

Outlook

We expect revenue to decline by 4% to 5% in the 2010 financial year, reflecting a continuation of the trends seen towards the end of the 2009 financial year, the impact of lower mobile termination rates, together with the impact of refocusing BT Global Services.

We expect to deliver a net reduction in group capital expenditure and operating costs of well over £1bn in 2010. Included within this is a reduction in group capital expenditure to around £2.7bn. As a result, we expect group free cash flow, before any pension deficit payments, but after the cash costs of the BT Global Services restructuring charges, to reach over £1bn in 2010 and beyond.

Earnings per share will be impacted by the movement of the net finance expense on the pension obligations which moves from a credit of £313m in the 2009 financial year to a charge of about £275m in 2010.

The proposed final dividend of 1.1p gives a full year dividend of 6.5p which rebases dividend payments to a level we are confident is sustainable. The Board is committed to delivering attractive returns for shareholders and believes that the operational improvements in the business will generate sufficient cash flow to allow the dividend to grow at the same time as investing in the business, reducing debt and supporting the pension scheme.

[a] Items presented as adjusted are stated before contract and financial review charges and specific items.

[b] Adjusted basic earnings per share and free cash flow are non-GAAP measures provided in addition to disclosure requirements defined under IFRS. The rationale for using non-GAAP measures is explained on pages 33, 47 and 48, and a reconciliation of adjusted basic earnings per share and free cash flow, to the most directly comparable

IFRS indicator, is provided on pages 39 and 41 respectively.

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BUSINESS AND FINANCIAL REVIEWS BUSINESS REVIEW

BT Global Services order intake (£m)

How we are structured

We have four customer-facing lines of business: BT Global Services, BT Retail, BT Wholesale and Openreach. These are supported by two internal functional units: BT Design and BT Operate.

BT Retail, BT Wholesale and Openreach operate mainly in the UK, where we are the largest communications services provider to the residential and business markets. BT Global Services operates in the UK and globally.

BT is one of Europe s largest and most successful communications wholesalers to other communications providers (CPs). In the UK we support CPs through BT Wholesale and Openreach, and internationally through Global Telecoms Markets, an operating unit of BT Global Services.

We have integrated our networks, IT and testing facilities which are managed by BT Design and BT Operate. Specifically, BT Design deploys platforms, IT systems and processes that support our products and services, while BT Operate is responsible for making sure they run smoothly. Neither generates external revenue.

Line of business financial performance

The financial performance of each of the lines of business for 2009, 2008 and 2007 is discussed in this **Business review**. We measure the financial performance of BT Retail, BT Wholesale and Openreach based on EBITDA and operating profit before specific items. For 2009, we measure the results of BT Global Services on an adjusted basis, being before the impact of contract and financial review charges and specific items. For further discussion of these items see pages 33 and 47 to 48. A reconciliation of adjusted EBITDA to group operating profit (loss) by line of business, and for the group, is provided in the table at the foot of pages 34 to 35.

BT Global Services

Business overview

BT Global Services is a provider of networked IT products, services and solutions. We aim to be the partner of choice for large enterprise and government customers in the UK and globally.

We have created a powerful combination of networked IT and professional services capabilities together with strong customer partnerships, investing and innovating together to build long-term value.

The Gartner Group s research organisation recognises BT as a global leader in Gartner s Magic Quadrant for Network Service Providers, and industry analyst Telemark Services has given BT its platinum award, reflecting customer satisfaction with our delivery of global data virtual private network services, regarded as best in class.

Customer service improvements in 2009 included a reduction of more than 40% in the average time to provide international MPLS services and a 6% improvement in the delivery of international repairs within the target time.
We have more than 3,400 points of presence in more than 170 countries. We are the largest supplier of networked IT services to -UK national and local government.

Despite these strengths, during 2009 the level of profitability in BT Global Services fell significantly.

As explained in the **Principal risks and uncertainties** section in this year s and previous years annual reports, our pricing, cost and profitability estimates for major contracts generally include long-term cost savings that we expect to make over the life of the contract. In 2009, a failure to achieve these anticipated savings made a number of these contracts less profitable or even loss making, adversely impacting our profits.

Actions taken

The Board changed the senior management team within BT Global Services, with a new Chief Executive for the division appointed in October 2008. The new team s brief was to address the cost base, to bring greater focus to the profitability of new contract wins and to reduce shortfalls in delivery performance on existing contracts. The new management team undertook an extensive review of BT Global Services financial position, contracts and operations. The financial review covered the financial performance of BT Global Services and its balance sheet position. The contract reviews covered the largest and most complex contracts and were conducted jointly with external advisors. Having completed the contract and financial reviews, a charge of £1.6bn was recognised, which includes £1.2bn relating to the two major contracts that are the subject of ongoing commercial negotiations. These charges reflect a more cautious view of the recognition of future cost efficiencies and other changes in underlying assumptions and estimates, particularly in the light of the current economic outlook. £1.3bn of the total charge relates to contract costs which had been previously capitalised on the balance sheet.

BT Global Services management team is implementing a number of process improvements. Some of these were in place by the end of 2009, the rest are being implemented in 2010. These include undertaking more regular contract reviews to assess commercial risks and opportunities as part of a strengthened contract governance process that combines operational, financial and risk reporting. Additional scrutiny of contracts and cost transformation plans have been put in place and will continue to be conducted on a rigorous and regular basis involving strong independent oversight of assumptions and estimates for new and existing contracts. We are also placing greater focus on profitable sectors, setting stringent win criteria and enhancing due diligence around our ability and readiness to meet our delivery requirements on all major contracts.

Immediate action has also been taken to address the cost base, with particular focus on external procurement and total labour resource. We reviewed rates across our contractor base, and successfully reduced these rates by up to 35%. We have addressed spend of £450m with suppliers across seven categories of expenditure, including our contractor base, and have successfully

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BT Global Services new structure

renegotiated contracts, resulting in price reductions of 12% on average, and up to 35% in some categories. In addition, we have focused on a number of areas of significant discretionary expenditure including travel, consultancy and conferencing and have achieved reductions in these areas. These actions are expected to deliver sustainable cost reductions in the 2010 financial year.

How BT Global Services is changing

The operational review was completed towards the end of 2009, resulting in a revised operating model and restructuring plan which will reshape and refocus the business, further enhancing BT Global Services ability to serve customers and establish a significantly lower cost base.

Under the new operating model, BT Global Services will focus on three customer segments:

- being the number one provider of networked IT services to corporate and public sector customers in the UK, building on BT Global Services strong market position and the group s 21CN products and services
- providing networked IT services to key multinational customers, differentiating BT Global Services through seamless global connectivity and delivery of BT s core portfolio of products and services
- creating a BT Global Services Enterprises unit consisting of a discrete portfolio of businesses addressing specific customer needs in key countries.

Significant structural changes are being implemented. The majority will be completed in 2010 in order to deliver the benefits of the new operating model which include:

- integrated sales, marketing, professional services, account management and delivery capability, competing effectively in each target market
- enhanced bid management and start-up processes to improve win rates on selected deals and ensure standardisation and quality of delivery
- a single global service model, consolidating a large number of individual centres into a small number of larger operational hubs, which will provide a single point of customer contact and enable improved right first time customer service
- continued rationalisation of systems and networks, reducing the number of systems by a third and halving the number of global networks, thereby removing duplication and enabling significant cost savings
- restructuring corporate support functions to serve the three customer segments more efficiently and effectively
- strategic partnering for sales, service and infrastructure.

As a result of this operational review, the group has recorded specific item restructuring charges of £280m in 2009, with further charges of approximately £420m in total expected to be recorded over the next two financial years, the majority in 2010. These charges predominantly arise from legacy networks and products rationalisation and restructuring costs associated with people and property. Further analysis of these charges, including their cashflow impact, is provided in the **Specific items** section of the **Financial review** on pages 36 to 37.

Market context

We believe that we have identified a clear path to a profitable and sustainable business, building on a strong market position.

The global networked IT services market is valued at around £600bn. We remain well placed to help our global customers reduce costs and streamline their businesses in a challenging market environment. We are seeing continued interest in network operational efficiency, workforce management, security, unified communications (including

Telepresence and conferencing) and global hosted contact centre solutions, as our customers respond to the current economic environment.

Operational performance

In the UK

We serve businesses in virtually every sector of British industry, from banking and finance to transport, logistics and the public sector. We have around 1,800 multi-site customers in the UK.

We continue to make progress on our N3, Spine and London Local Service Provider contracts with the National Health Service (NHS) National Programme for Information Technology (NPfIT), the largest non-military IT programme in the world.

Building on our work as the local service provider responsible for upgrading NHS IT systems in London, we have taken on the running of IT systems at eight acute hospitals in the South of England. In addition, we are working with a further four acute trusts in the South of England which have yet to roll out systems as part of NPfIT, as well as implementing 25 new systems in community and mental health trusts in the region.

We are deploying one of the world s largest converged IP networks for the Department for Work and Pensions to be completed in 2010.

Reinforcing our presence in the local government sector, we agreed a ten-year strategic partnership with South Tyneside Council, worth more than £180m for delivery of a number of key council services. We also won an extension to our existing arrangement with Liverpool City Council and a new contract with Sandwell Metropolitan Borough Council and two contracts with Norfolk County Council with a combined value of £40m to provide voice and data services and a schools internet service.

We are the official communications services partner for the London 2012 Olympic Games and Paralympic Games. This involves the provision and management of voice and data networks, internet access and land lines required at each of the London 2012 Games venues.

We signed a number of deals with major UK corporate sector customers including:

4 a seven-year, £160m outsourcing deal with Nationwide Building Society to manage its networked IT services

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BT Global Services UK/Non UK revenue (£m)

4 a three-year contract extension with Manpower to provide fully managed global wide area network (WAN) infrastructure and managed services

4 a five-year contract with Carillion worth £32m for voice/hosted voice, IP data, conferencing and private automated branch exchange (PABX) maintenance.

Outside the UK

BT Global Services signed orders with 529 new customers outside the UK in 2009 and we continued to strengthen our business with large multinational corporations.

We signed a number of major deals in 2009, including:

4 a five-year, US$526m contract with Procter & Gamble to provide and manage local area network (LAN) and WAN infrastructure in more than 80 countries

4 a contract with BMW to manage a large part of its communications infrastructure, including voice over IP (VoIP), contact centres, email services and videoconferencing

4 a three-year managed services contract with SWIFT to connect strategic offices across Europe, the US and Asia with BT s unified communications video solution

4 a three-year contract with Munich Re to provide security and network services in 33 countries

4 a contract with the Emirates airline to consolidate and manage its worldwide contact centres

4 a seven-year, 118m extension of current services provided to Syngenta for data and voice services plus deployment of IP telephony, managed LAN and BT OneVoice to 112 sites and the deployment of BT managed mobile services to 13 countries.

Successes in the public sector outside the UK included a contract with Barcelona City Council for 500 wireless broadband hot spots, providing free internet access across the city, and a contract with the Colombian government supporting digital inclusion under which BT will convert 755 public schools into telecentres and provide additional bandwidth to a further 1,150 schools.

We are also part of the Match consortium that won a 30m contract with the Dutch Ministry of Home Affairs for the housing and hosting of the national government s IT infrastructure.

Financial performance

	2009 £m	2008 £m	2007 £m
Revenue	8,828	7,889	7,312
Adjusted gross profit[a]	2,576	2,839	2,759
Adjusted SG&A costs[a]	2,267	1,978	2,024
Adjusted EBITDA[a]	309	861	735
Contract and financial review charges	1,639		
EBITDA[b]	(1,330)	861	735
Operating (loss) profit[b]	(2,106)	117	70

a

Adjusted items are before contract and financial review charges and specific items.

[b] Before specific items.

In 2009, BT Global Services revenue increased by 12% to £8,828m (2008: £7,889m, 2007: £7,312m), compared with growth of 8% in 2008. Revenue in 2009 includes the impact of foreign exchange rate movements of £588m and acquisitions of £368m. Excluding these, underlying revenue was £7,872m, compared with reported revenue of £7,889m in 2008. Revenue from outside the UK has increased to 47% of BT Global Services total revenue (2008: 40%, 2007: 36%), reflecting the impact of organic growth as well as the impact of foreign exchange rate movements and overseas acquisitions.

Revenue from managed network solutions increased by 17% to £5,328m, compared with growth of 10% in 2008. The increase was driven by growth in revenue from both networked IT services and MPLS and reflects the impact of foreign exchange rate movements and acquisitions, together with substitution of UK calls and lines. Revenue from calls and lines decreased by 8% to £1,095m, compared with a decline of 6% in 2008. The decrease was due to the gradual decline in this revenue stream as customers switch to more email, IP network and conferencing products as shown by the growth in managed network solutions. Other revenue increased by 12% to £2,049m, compared with a growth of 11% in 2008. The increase was mainly driven by growth in revenue from the global carrier business and reflects the impact of foreign exchange rate movements and acquisitions. During the year, we won new networked IT services contracts worth £5.5bn (2008: £5.0bn, 2007: £5.2bn). Networked IT services contracts represent 68% of our total order value of £8.0bn (2008: £8.0bn, 2007: £9.3bn).

Adjusted gross profit decreased by 9% to £2,576m in 2009 (2008: £2,839m, 2007: £2,759m), compared with an increase of 3% in 2008, primarily due to high costs and the continued decline in higher margin UK business. Including the impact of the contract and financial review charges of £1.6bn, gross profit in 2009 decreased by 66% to £965m.

Gross profit is revenue less costs directly attributable to the provision of products and services reflected in revenue in the period. Selling, general and administrative (SG&A) costs are those costs that are ancilliary to the business processes of providing products and services and are the general business operating costs.

Adjusted SG&A costs increased by 15% to £2,267m in 2009 (2008: £1,978m, 2007: £2,024m), compared with a decrease of 2% in 2008. SG&A costs include the impact of foreign exchange rate movements of £221m and acquisitions of £170m. Excluding these, underlying adjusted SG&A costs decreased by 5% to £1,876m, reflecting the renewed focus from the new management team on total labour resource, supplier negotiation and discretionary and general overhead expenditure in the second half of 2009. Including the impact of the contract and financial review charges of £28m included within SG&A costs, SG&A costs increased by 16% to £2,295m.

The decrease in gross profit together with the impact of higher SG&A costs resulted in adjusted EBITDA of £309m, a reduction of £552m compared with 2008. In 2008, EBITDA increased by 17% to £861m. Depreciation and amortisation increased by 4% to £776m

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Average annual revenue per consumer household (£)

(2008: £744m, 2007: £665m), compared with an increase of 12% in 2008. The increase reflects the increased investment in our global infrastructure, customer related capital expenditure and the impact of acquisitions, as well as the impact of foreign exchange movements.

The above factors resulted in an operating loss of £2,106m, compared with an operating profit of £117m in 2008 (2007: £70m).

BT Retail

Business overview

BT Retail aims to help its customers enhance the way they live their lives and run their businesses. At home we enable our customers to keep in touch with friends and families and to enjoy fast, reliable, secure and safe connection to the internet. We are bringing broadband to the TV and TV to broadband so that people can watch what they want when they want. At work we serve small and medium-sized enterprises (SMEs) (typically with up to 1,000 employees, although some are significantly larger) and enable them to cut their costs and improve their service by using communications and IT services that were once available only to the largest businesses. We do this by taking the drudgery out of implementing new technologies so our customers can focus on doing what they do best.

There are four divisions in BT Retail: BT Consumer, BT Business, BT Ireland and BT Enterprises.

We are the UK s largest communications provider, with 20.7m fixed lines and 4.8m broadband lines.

Market context

Market conditions have been challenging: the rate of growth in demand for broadband has been slowing as the market matures and competition intensifies, both from local loop unbundlers with large customer bases to whom they can sell broadband, and from the mobile operators who are now offering mobile broadband as well as mobile voice. At the same time the economic downturn is causing business and personal customers to shop around for the very best value.

We have responded by offering customers complete packages that meet their needs and deliver great value for money.

Operational performance

BT Consumer

Voice

We offer value for money services with three main packages of calls and lines Unlimited Weekend Calls, Unlimited Evening and Weekend Calls and Unlimited Anytime Calls. All offer competitive terms but customers who use us the most receive the best value.

In 2009, we announced our new Friends & Family Mobile scheme which now offers discounts of up to 40% on calls to mobiles making it cheaper to call a mobile from a BT landline than from prepay mobiles. We also announced that calls to 0845 and 0870 numbers would be included for free in our packages a first for the UK market.

Our new BT Basic tariff offers very low line rentals to vulnerable customers on low income benefits. We are the only communications provider in the UK to provide this service. In addition we design our handsets to be inclusive and meet the needs of older and disabled customers.

Our range of handsets won praise in 2009 for its contribution to reducing carbon emissions with new energy saving power supplies.

Broadband

BT Total Broadband is the UK s most popular broadband service. We offer a more complete experience than our rivals by including in the price all the extras customers need to have a safe and enjoyable broadband experience. For example, we offer McAfee security on up to seven PCs in the house, and Digital Vault, which enables customers to back-up valuable digital material including music and pictures.

The BT Home Hub is at the centre of BT Total Broadband. It has an iconic design and is the market-leading wireless router. Its latest release offers unbeatable wireless coverage and reduced energy consumption.

Some customers want access to the internet on the move. We offer these customers 3G dongles as part of their Total Broadband package. Further, BT FON enables customers who agree to share a small, secure section of their home broadband connection access to broadband via other BT FON members locations and BT Openzone Wi-Fi hotspots. Between them, BT Openzone and BT FON offer BT customers the chance to get online at more than 150,000 locations in the UK and Ireland and another 50,000 locations worldwide through roaming partners.

We also offer lower priced broadband and voice services under the award winning Plusnet brand. Acquired in 2007, Plusnet offers customers a leading online self-service experience.

BT was named as the Reader s Digest most trusted internet service provider (ISP) and voted joint top for broadband customer service in a poll conducted by the Broadband Genie comparison website.

BT Vision

Consumers increasingly want to buy telephony, broadband and TV from a single provider. BT Vision our on-demand television service enables us to meet these needs. It is available on subscription or pay-per-view terms.

BT Vision gives customers access to more than 70 TV and radio channels and pay-per-view services from a wide range of content providers, including blockbuster movies and live Premiership football. At 31 March 2009, BT Vision was the UK s largest on-demand service with more than 5,000 hours of programming available.

The take-up of BT Vision accelerated during the financial year. By the end of March 2009, we had 423,000 customers, around double the number at the end of the previous year. More customers

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BUSINESS AND FINANCIAL REVIEWS BUSINESS REVIEW

BT Retail broadband market share* year end (000 lines)

* DSL + LLU installed base

opt for the subscription unlimited views packs and subscribers viewing of the service has more than tripled.

In December 2008, we announced a partnership with the BBC and ITV to launch a new digital entertainment platform (subject to any relevant approvals). The new platform aims to build on BT Vision and Freeview and will bridge the gap between two previously separate technologies, bringing TV to broadband and broadband to the TV. It will combine free digital channels with free on-demand content from the public service broadcasters as well as pay-TV delivered over the broadband line. We aim to launch the service in mid 2010.

BT Business

Voice

In the business voice market, we aim to simplify the management of communications, give better value for money and drive innovation so that customers get more benefit from their investment in communications. We have seen strong take-up from customers for packages that bring together calls, lines, broadband and mobile, with consistent service (BT Business One Plan). At 31 March 2009, BT Business One Plan had more than 460,000 locations, and accounted for 35% of call revenues from business customers.

We have seen an increased take-up of voice over IP (VoIP) and are developing services that use the internet to integrate voice with other business applications.

We have seen strong growth in conferencing, with customers using communications to reduce business travel costs.

We have made communications-enabled applications a reality with the launch of Ribbit for salesforce.com. This service makes it easy for sales professionals to update key customer relationship management (CRM) systems using seamless voice-to-text technology, both from the desk and on the move.

Broadband

BT Business remained UK SMEs preferred internet service provider. During 2009, we enhanced this service to include mobile broadband. Customers are provided with a plug-and-play 3G dongle, enabling them to connect and work wherever they are. We also reduced entry-level prices to support customers feeling the impact of the recession. When we sell broadband to customers, we also offer them value-added services and now have an attachment rate of 113% (ie on average we sell a little more than one value-added service every time we sell a broadband service). We have seen strong growth in web hosting in particular, as customers recognise the benefits of seamless business-grade service for hosting and internet access.

Mobility

We have seen strong growth in mobile sales. Our focus has been on helping customers work on the move rather than just making mobile phone calls and this approach has driven strong growth in mobile messaging especially in the sale of BlackBerry smart phones. We have also seen growing sales of business applications and are seeing strong growth in telemetry solutions.

Other services

The creation of BT Engage IT (incorporating Basilica and Lynx, which we acquired in September 2007) enables us to offer customers a wide range of IT services, including data centre virtualisation, unified communications and managed services. We have seen good growth with mid-market companies and are also growing our customer solutions business to provide fully managed and outsourced IT and communications solutions.

We see great potential in the development of cloud computing as a way of delivering IT services to SMEs at significantly lower prices and with considerable benefits of simplicity, security and agility. We are leading with business applications, exploiting the growing trend towards software as a service whereby SMEs access and use applications over the internet as and when they need it rather than paying to have the applications permanently on their own computers. As an example we are working with salesforce.com to enable our SME customers to access customer relationship management (CRM) systems of a sophistication previously only available to very large companies, with support and service from BT.

We continue to grow BT Tradespace, our online trading community that brings businesses and individual sellers together with potential customers and partners. At 31 March 2009, there were 338,000 members of the BT Tradespace community, and we were adding around 2,500 each week. Towards the end of the financial year, we launched a number of enhancements including tools that enable service businesses to take bookings over the web, and support SMEs in search marketing.

BT Ireland

BT Ireland operates across Northern Ireland and the Republic of Ireland.

We are one of the leading communications providers to consumers and SMEs in Northern Ireland. We are also one of the leading networked IT services partners of government and major customers and are responsible for providing regulated wholesale access via Openreach.

In the Republic of Ireland we are a leading provider of networked IT services to government and major businesses, and one of the largest and most successful providers of wholesale network services. We are one of the largest DSL broadband providers to consumers and SMEs.

We gained significant traction in the private and public sectors and secured a number of the largest managed services contracts awarded in the market. O_2 Ireland outsourced its network operations to BT in a seven-year deal, while 3 Ireland selected BT as its principal subcontractor to support the delivery of the National Broadband Scheme. The Scheme is run by the Department for Communications, Energy and Natural Resources with the aim of achieving broadband availability throughout the Republic of Ireland. Other key contracts were won in the banking, engineering and public sectors.

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BT Retail external revenue by unit (%)

We continued the rollout of our 21CN, which delivers carrier grade Ethernet services for both mobile operators and specifically to support the delivery of our new managed services contracts with 3 Ireland and O_2. Our investment in local loop unbundling (LLU) is bringing broadband with speeds of up to 24Mb to telephone exchanges serving over 330,000 homes and businesses in the Republic of Ireland, and in March 2009 we were delighted to announce that Belfast would be one of the first regions in the UK to benefit from BT s investment in super-fast broadband.

BT Enterprises

Enterprises are a number of stand-alone businesses, including:

4 BT Conferencing a leading global provider of audio, video and internet collaboration services

4 BT Directories comprising Directory Enquiries (118 500), operator and emergency services, and The Phone Book. In July 2008 we acquired Ufindus, supporting the increasing demand for online directory enquiries

4 BT Payphones providing street, managed, prison, card and private payphones

4 BT Redcare providing alarm monitoring and tracking facilities

4 BT Expedite offering integration solutions and services to retailers

4 BT Shop and dabs.com a leading internet-based retailer of IT and technology products.

BT Conferencing was one of the main drivers of growth in Enterprises in 2009. Conferencing services are attractive to customers because they can help to save travel costs and reduce environmental impact. The acquisition of Wire One Holdings Inc (Wire One) one of the leading providers of videoconferencing services in the US enhanced BT Conferencing s position as the leading videoconferencing operator in the world.

Efficiency

Although we continue to invest in new products and services, there is an intense focus on cost transformation activities in all parts of BT Retail. We have a range of programmes which aim to improve the customer experience and take the cost of failure out of the business. Customer service improvements included a 65% reduction in the time it takes consumer customers to get through to an adviser and a 20% improvement in the average time to clear network telephony faults experienced by business customers.

Financial performance

	2009	2008	2007
	£m	£m	£m
Revenue	8,471	8,477	8,346
Gross profit	3,186	3,114	2,938
SG&A costs	1,552	1,619	1,581
EBITDA	1,634	1,495	1,357
Operating profit	1,209	1,050	912

In 2009, BT Retail revenue was flat year on year at £8,471m (2008: £8,477m, 2007: £8,346m), reflecting growth in revenue from broadband and convergence, managed solutions and conferencing, offset by a decline in revenue from calls and lines. Revenue includes £65m in respect of foreign exchange rate movements and £146m in respect of acquisitions. Excluding these, underlying revenue of £8,260m declined by 3% compared with reported revenue in 2008. In 2008, revenue increased by 2%, driven by growth in broadband and managed solutions revenue, which was only partially offset by a decline in calls and lines revenue.

	2009	2008	2007
	£m	£m	£m
BT Retail external revenue			
Managed solutions	519	456	361
Broadband and convergence	1,298	1,189	985
Calls and lines	4,825	5,167	5,409
Other	1,470	1,382	1,345
Total external revenue	**8,112**	**8,194**	**8,100**
Internal revenue	359	283	246
Total	**8,471**	**8,477**	**8,346**

Managed solutions revenue increased by 14% to £519m in 2009 (2008: £456m, 2007: £361m) due to growth in BT Business and reflecting the acquisitions of Basilica and Lynx in the second quarter of 2008. Towards the end of 2009 the group saw a slowdown in new contracts, reflecting the impact of the current economic environment on the SME sector.

Broadband and convergence revenue increased by 9% to £1,298m in 2009 (2008: £1,189m, 2007: £985m), reflecting the successful retention of customers in the maturing broadband market, together with revenue from services such as BT Vision and mobility. The broadband installed base increased by 355,000, to 4.8m customers at 31 March 2009. These net additions represented a 31% share of the total broadband DSL and LLU net additions in 2009. At 31 March 2009, our share of the installed base was 34% (2008: 35%, 2007: 34%).

Calls and lines revenue decreased by 7% in 2009 to £4,825m, compared with a decrease of 4% in 2008. The acceleration of the decline in 2009 reflects the increasingly competitive environment and further market declines.

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DSL broadband connections year end (m)

Other revenue increased by 6% to £1,470m in 2009 (2008: £1,382m, 2007: £1,345m), driven by growth in BT Conferencing and the acquisition of Wire One in May 2008.

Gross profit increased by 2% in 2009 to £3,186m (2008: £3,114m, 2007: £2,938m), compared with an increase of 6% in 2008. Gross profit margin increased by 0.9% to 38% in 2009, showing steady growth across all three years under review (2008: 37%, 2007: 35%).

SG&A costs were £1,552m in 2009, compared with £1,619m in 2008 and £1,581m in 2007. The 4% reduction in SG&A costs was driven by a focus on cost transformation, labour efficiency and supplier savings, being partially offset by the integration of acquisitions and foreign exchange. Excluding the impact of acquisitions of £34m and foreign exchange movements of £12m, underlying SG&A costs of £1,506m reduced by 7% in 2009. The increase in SG&A costs in 2008 was driven by extra investment in product development, marketing and acquisitions, the impact of which was partly offset by savings from cost efficiency programmes.

The above factors resulted in EBITDA increasing by 9% to £1,634m in 2009 (2008: £1,495m, 2007: £1,357m), and a 15% improvement in operating profit to £1,209m in 2009 (2008: £1,050m, 2007: £912m).

BT Wholesale

Business overview

BT Wholesale s strategy is to transform itself from a traditional, high-volume product wholesaler, to a next generation communications products wholesaler and managed solutions provider. We are establishing BT as a leading provider of innovative managed network solutions that will enable our customers to serve their customers, manage their costs and transform their businesses. This means helping our customers operate in a network lite way. If they have their own infrastructure and platforms, we can manage them. If they do not, we can provide them.

Our customers gain access to BT s platforms, skills, investment and technology, and can benefit from the economies of scale we bring.

BT Wholesale has around 700 customers in the UK, comprising fixed and mobile operators, internet service providers and other communications providers (CPs). BT Wholesale leads the wholesale sector worldwide, working closely with the Global Telecoms Markets unit of BT Global Services to meet our wholesale customers global requirements.

We manage around 60% of the ADSL broadband lines traffic in the UK and support the voice requirements of more than a third of all homes and businesses. We also play a central role in helping mobile operators manage the connections between their base stations and the core UK network.

Market context

Increasingly, our customers are positioning their businesses as service providers rather than network operators. Many of the services they provide are extremely bandwidth hungry and this presents CPs with a challenge. Particularly at a time of economic downturn, they may be reluctant to commit to the high levels of capital investment that network renewal requires. This presents BT Wholesale with opportunities to supply a range of managed network and outsourced services.

Consolidation continues to impact BT Wholesale s market, as do broadband volume decreases resulting from LLU migrations. Regulation also continues to have a major impact on our business, including the reduction in mobile termination rates internationally.

Operational performance

Managed network solutions

To date, we have signed managed network solutions contracts with eight of our top 15 customers by revenue. These contracts are typically for between three and five years and enable us to build long-term, mutually beneficial relationships.

In the year, we signed managed network solutions contracts worth a projected total of £1.2bn over their lifetimes. These included:

4

in June 2008, we announced a three-year deal with Sky to provide it with wholesale voice services to support over one million Sky Talk customers and in February 2009 we announced an agreement to provide Sky with a managed directory enquiries service

4 in August 2008, we signed a five-year managed network solutions agreement with Mobile Broadband Network Limited (MBNL) on behalf of the joint venture partners 3 UK and T-Mobile UK to provide and manage high-speed connectivity between their base stations and our core national network in the UK.

The managed network solutions business is growing rapidly and accounted for 15% of BT Wholesale s external revenue in 2009, up from 8% the previous year.

White label managed services

At 31 March 2009, 4.1m UK homes and businesses were receiving voice and broadband services through our white label platforms. White label managed services are provided to customers who have not invested in their own infrastructure but who want to enter new markets quickly. These customers market such services under their own brands, even though we frequently manage them end to end, from taking orders to issuing bills. Our customers for such services include the Post Office and Scottish and Southern Electricity.

Wholesale products

Wholesale Ethernet

BT Wholesale offers high-speed Ethernet services across the widest national footprint in the UK market. Enabled by 21CN, these services offer customers high-speed data connectivity, resilience

BUSINESS AND FINANCIAL REVIEWS BUSINESS REVIEW

and flexibility. At 31 March 2009, 21CN Ethernet was available from more than 600 nodes throughout the UK.

Wholesale broadband

We continued to develop a variety of tools and techniques to help our customers deliver an excellent broadband experience to end users and get more from their broadband connections. The I-Plate, for example, is a self-installable device that can be fitted to an end user s master telephone socket to improve broadband speeds by eliminating electrical interference.

Wholesale Broadband Connect, our next generation 21CN broadband service, offers customers average speeds of around 10Mb, guaranteed service level agreements, the ability to trade speed for stability, and enhanced line diagnostics. At 31 March 2009, less than a year after it was first introduced, this service was available from exchanges serving more than 10m homes and businesses, around 40% of the UK addressable market.

Capacity and call-based products

We continue to sell a wide range of capacity and call-based products and services, including regulated interconnect services and new, non-regulated products and services. As we refresh our core portfolio with next generation replacements, we will, over time, migrate these services to 21CN, enabling the decommissioning of certain parts of our legacy systems.

Efficiency

In 2009, we maintained our focus on the cost reduction opportunities that arise as our business changes. We reduced BT Wholesale s cost base by 19% through headcount reduction (down 17% in the year on a like-for-like basis), eliminating duplication, achieving further operational efficiencies and aligning our resources more effectively with the evolving needs of our customers. By March 2009, 99% of broadband circuits were delivered to customers by the day promised, our best ever performance.

Financial performance

	2009 £m	2008 £m	2007 £m
Revenue	4,658	4,959	5,386
Internal revenue	1,228	1,252	1,277
External revenue	3,430	3,707	4,109
Gross profit	1,427	1,593	1,796
SG&A costs	161	198	296
EBITDA	1,266	1,395	1,500
Operating profit	580	502	592

In 2009, BT Wholesale revenue declined by 6% to £4,658m (2008: £4,959m, 2007: £5,386m), an improvement in the rate of decline compared with the previous year (2008: 8%). Broadband revenue decreased by 23% to £482m (2008: £624m, 2007: £771m) primarily due to the continued trend of CPs switching to LLU provided by Openreach. Revenue from the transit business declined by 16% to £1,134m (2008: £1,349m, 2007: £1,485m), compared with a decline of 9% in 2008. The decline in the transit business has arisen as mobile operators build their own networks and are able to bypass BT. These declines, however, have been partially offset by growth in the managed network solutions business, where revenue increased by 76% to £518m (2008: £295m, 2007: £306m), principally due to new contracts signed in the year.

Gross profit decreased by 10% to £1,427m in 2009 (2008: £1,593m, 2007: £1,796m), a marginal improvement in the rate of decline compared with the previous year (2008: 11%). BT Wholesale reduced the gross margin impact of the revenue declines through focused margin management initiatives. The impact of some of the downward trends on our revenue and gross margin has been offset by our continued focus on reducing costs. In 2009, SG&A costs decreased 19% to £161m (2008: £198m, 2007: £296m) compared with a reduction of 33% in 2008. BT Wholesale has benefited from continued cost efficiency programmes including the right first time initiative, which aims to reduce or eliminate the cost of failure from existing processes.

EBITDA decreased by 9% to £1,266m in 2009 (2008: £1,395m, 2007: £1,500m), compared with a decrease of 7% in 2008. EBITDA margin in 2009 was 27%, compared with 28% in 2008 and 2007. Depreciation and amortisation decreased by 23% to £686m as a result of lower depreciation on legacy assets (2008: £893m, 2007: £908m). Largely due to lower depreciation and amortisation, operating profit increased by 16% to £580m in 2009, compared with a decrease of 15% to £502m in 2008 (2007: £592m).

Openreach

Business overview

Openreach is responsible for the crucial first mile of the telecommunications network in the UK. It offers all CPs (currently, more than 420) including other BT lines of business fair, equal and open access to our access and backhaul networks.

One of the UK s vital infrastructure assets, this first mile connects millions of homes and businesses to local telephone exchanges, via fixed-line local and backhaul connections.

Openreach s 21,000 field engineers 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. It is committed to delivering a better network and an environment in which its customers can thrive.

Our strategy in 2009 was to continue to deliver and comply with the Undertakings made to Ofcom, while driving efficiencies, providing the right levels of resourcing and enhancing service levels.

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£1.5bn
planned investment in super-fast broadband

Market context

In spite of the current economic downturn and increasing competition in the local access market, the use of Openreach s fixed-line network for the provision of broadband services continues to grow. This growth is driven by the increasing numbers of homes with personal computers, intense competition between CPs driving improved and cheaper products, and the need for ever higher bandwidth. Prior to the delivery of Openreach s super-fast access product, some CPs have started to compete on bandwidth over our copper network by investing in new technologies such as ADSL2+ and bonded copper.

We also saw growth in the Ethernet market as CPs are under pressure to transfer large quantities of data to support the growth of new applications. In 2009, Openreach continued to protect its market leading position in the provision of Ethernet services by investing in its product portfolio to provide greater flexibility and increased bandwidth and setting more competitive prices.

Operational performance

Service performance

In 2009, Openreach made significant improvements in the quality of service delivery of its products. The number of provision and repair orders that did not meet target delivery dates in 2009 reduced by nearly three quarters and over a third, respectively. There has been a more than 65% reduction in the number of customers waiting more than three days for a fault to be fixed.

In addition to reactive provision and repair, improved service requires investment in reinvigorating the access network infrastructure. In 2009, Openreach invested £63m in a proactive maintenance programme, which reduced access fault rates by more than 20% in the year.

Openreach operates a large fleet of more than 20,000 vehicles and is committed to finding innovative ways to minimise its environmental impact. In addition to introducing more efficient vehicles to the fleet and modifying racking systems to reduce vehicle weight, we are also conducting trials of electric and other alternative vehicle technologies. Openreach was awarded Transport for London s Greenfleet Private Sector Fleet of the Year Award in 2009.

Delivering on the Undertakings

During 2009, Openreach continued to deliver on its Undertakings made to Ofcom (see **Regulation**, pages 26 to 27), including further physical separation of customer records and migration of customers over to equivalent analogue and digital wholesale line rental (WLR) products. As we have now delivered a large proportion of the Undertakings, the emphasis is increasingly on ongoing monitoring. In 2009, a programme of compliance health checks was completed and periodic reporting against KPIs was initiated.

Openreach products

Wholesale line rental

WLR enables CPs to offer telephony services with their own brand and pricing structure over BT s network.

At 31 March 2009, Openreach was providing 20m WLR lines to other BT lines of business and 5.6m to other CPs. Of the lines provided to other CPs, 4.6m were WLR analogue lines (up 21% on 2008) and 1.0m were WLR digital channels (up 19% on 2008).

Local loop unbundling

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.

At 31 March 2009, there were 13.8m unbundled lines in the UK (up 9% on the previous year). Of these, 8.1m were for BT lines of business and 5.7m were for other CPs. More than 20 CPs were providing unbundled services and Openreach was fulfilling more than 94,000 LLU orders a week.

Ethernet

Openreach s Ethernet products offer CPs a wide choice of high-bandwidth circuits to build or extend their customers data networks. We made major reductions in the connection and rental costs of services in our Ethernet portfolio with effect from 1 February 2009, which support and improve the access and backhaul markets in the UK at lower cost and support the growth of data-intensive applications.

Next generation access

Starting in summer 2009, Openreach will be running operational pilots of fibre to the cabinet (FTTC) between the exchange and customer premises. Two exchanges one in Muswell Hill in North London and one in Whitchurch, South Glamorgan will conduct FTTC pilots involving up to 15,000 customer premises in each area. End users should experience headline speeds of up to 40Mb.

We plan to make fibre available to 1m homes and businesses throughout the UK early in the 2010 calendar year. Parts of Belfast, Cardiff, Edinburgh, Glasgow, London and Greater Manchester will be involved in the initial deployment, as well as two rural locations Calder Valley (near Halifax) and Taffs Well (near Cardiff). Openreach will deploy the technology, but CPs will develop and sell services based on it.

We already provide Ethernet-based fibre to the premises of more than 130,000 businesses in the UK. Since August 2008, as part of an initial trial, Openreach has been deploying fibre to the premises (FTTP) on a new 1,000 acre greenfield site at Ebbsfleet Valley in Kent. At this site, Openreach is offering the communications industry a wholesale fibre-based broadband product, facilitating competition at a retail level. The service can support speeds of up to 100Mb the fastest headline speed available to residential customers in the UK.

BUSINESS AND FINANCIAL REVIEWS BUSINESS REVIEW

Efficiency

Openreach s continued focus on service resulted in some significant cost savings in 2009. Investment in reducing the number of engineer visits, providing training to enhance good workmanship and the introduction of new technology to diagnose network faults before they occur have helped lower Openreach s direct labour requirements. This, together with reduced demand resulting from the economic downturn, has enabled us to reduce the number of contractor and agency staff by 40% and the number of permanent employees by 4%.

We also achieved efficiencies in our non-pay costs. Supplier contract renegotiations, engineering process improvement and reduced service level guarantee payments as a result of improved network reliability and more orders delivered right first time have all helped to reduce costs further.

Financial performance

	2009 £m	2008 £m	2007 £m
Revenue	5,231	5,266	5,223
Internal revenue	4,253	4,380	4,538
External revenue	978	886	685
Operating costs	3,235	3,355	3,296
EBITDA	1,996	1,911	1,927
Operating profit	1,218	1,222	1,220

In 2009, Openreach revenue decreased by 1% to £5,231m (2008: £5,266m, 2007: £5,223m), compared with an increase of 1% in 2008. This decrease has been driven by reduced connections as the WLR and LLU markets react to the economic slowdown. Ethernet and LLU now forms just over 23% of our revenue, with WLR at 59%, reflecting the change in mix compared with 2007 when 18% of our revenue was from Ethernet and LLU and 64% was from WLR. This is the result of growth in the broadband market and unbundling activity taking place within the exchanges.

External revenue was £978m in 2009, an increase of 10% (2008: 29% increase) and reflects the continued growth of the broadband and Ethernet markets and active competition among CPs. The significant growth in 2008 was largely the result of high LLU connection revenue as CPs invested in growing their infrastructure. In 2009, CPs have focused more on obtaining returns from this investment, partly as a response to the changing economic environment. External revenues now form 19% of our revenue compared with 17% in 2008 and 13% in 2007.

Revenue from other BT lines of business decreased by 3% to £4,253m in 2009 (2008: £4,380m, 2007: £4,538m). These reductions reflect the shift of WLR and LLU volumes from other BT lines of business to external CPs. These reductions have been partially mitigated by the significant growth in the Ethernet portfolio, assisted by the launch of new products towards the end of 2009.

Operating costs decreased by 4% in 2009, compared with an increase of 2% in 2008. The decrease in the year reflects the success in our cost saving initiatives primarily around improving our service and structuring our business so it is better equipped with a more flexible and agile workforce for the future.

Over the past few years, we have made significant investments in improving our service. We have seen savings in our service level guarantee payments, which have reduced by 49% in 2009, despite starting to pay them out to external CPs proactively as opposed to on a claims basis.

EBITDA was £1,996m in 2009, a 4% increase year on year. In 2008, EBITDA reduced by 1%. EBITDA margin was 38% in 2009, compared with 36% and 37% in 2008 and 2007, respectively.

Depreciation and amortisation was £778m in 2009, 13% higher than 2008. In 2008, depreciation and amortisation decreased by 3%. The increase in 2009 is mainly driven by high value software being brought into use and the flow through of high capital investment in 2008. The reduction in the prior year was due to a number of the access network assets reaching the end of their useful economic lives.

Operating profit was £1,218m in 2009, broadly flat when compared with 2008 and 2007.

BT Design

BT Design is responsible for designing and building the platforms, IT systems and processes that support the products and services we provide to our customers around the world. It is also responsible for network planning and the implementation of BT s global 21CN platform.

The development activities undertaken by BT Design are aligned with customer needs and the requirements of BT s customer-facing businesses. BT Design has simplified and automated BT s processes so that customers can choose to do it all themselves, ask for managed services or a combination of the two. New products and services are created using agile development methods and resource management principles to increase the productivity of both in-house and third-party development resources. BT s platforms have been built in an open way to facilitate collaboration with third-party developers.

In 2009, BT Design was able to deliver significant cost savings for the group, largely as a result of a reduction in its workforce, at the same time as increasing output.

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BT was named the UK s strongest telecommunications brand in the 2009 Business Superbrands survey

BT Operate

BT Operate is responsible for making sure that BT s products and services run smoothly. It manages BT s IT and network infrastructure platforms as a single converged operation providing a seamless information and communications technology (ICT) infrastructure. BT Operate also runs parts of other CPs networks on behalf of the customer-facing lines of business. The scope of its operations enables it to achieve efficiency and avoid duplication and enhance our customers experience. BT Operate also sets and manages security policy and processes throughout BT enabling us to meet the security requirements of our customers, both in the UK and globally.

BT Operate manages the group s energy policy, which aims to reduce consumption, establish security of supply and reduce carbon emissions. The renewal of our green energy contract (in 2007) until 2010 means that we now meet approximately 40% of our electricity needs in the UK from renewable sources and almost 60% from combined heat and power generation. We are investigating how to use more renewable electricity or new technologies throughout our international operations.

We were one of the first companies in the UK to achieve the new, independently assessed Carbon Trust Standard certification, in recognition of our preparation for the UK Government s new Carbon Reduction Commitment. Starting in 2010, this new legislation will rank organisations in the UK on energy performance bonuses and penalties will be administered through the Environment Agency. Organisations will be required to purchase carbon allowances (effectively permits to use energy) at the start of each year.

In 2009, BT Operate achieved a significant reduction in its workforce, more efficient business operations and improved supply chain management.

Our resources

Our trusted reputation

We are proud to have a strong brand that is widely recognised in the UK and around the world. It helps to shape our relationships with customers and suppliers and between the people who work for the company. BT was named the UK s strongest telecommunications brand and 21st overall in the 2009 Business Superbrands survey. This ranks brands according to the views of an expert panel and more than 1,500 business professionals.

The strength of BT s brand is more valuable than ever, as customers turn to suppliers they know they can rely on. So, in turn, we have focused intensely on customer service in the past year and will continue to do so in the year ahead.

Our partnership with the London 2012 Olympic Games and Paralympic Games is a powerful signal of the inspiring and innovative brand we aim to be. We have already started delivering the communications services network for the 2012 Games at locations around the UK. We look forward to using our experience, people and technology to realise the potential of this exciting event over the next three years.

Our people

At 31 March 2009, BT employed around 85,000 full-time equivalent people in the UK and around 20,000 outside the UK. We also employ 42,000 people indirectly, through agencies and contractors, giving BT a total labour resource (TLR) of around 147,000.

Our aim is to create a team of high-performing, engaged and motivated people who can make a difference for customers, shareholders, the company and themselves.

Leadership

The quality of our leadership is vital to the transformation of BT. We ensure that leaders at all levels understand what is expected of them, including their sustainability obligations, have access to appropriate development opportunities and are able to benchmark their performance against that of their peers.

Learning and development

We offer employees a wide range of learning and re-skilling opportunities. Online and instructor-led courses are available through Route2Learn, our group-wide web-based learning portal.

Key to delivering excellent customer service is developing a customer-centric culture in BT, giving our people the skills and the tools necessary to ensure that every customer experience is an excellent one. A number of development initiatives designed to improve our right first time performance were launched in 2009.

BT employees are encouraged to volunteer in their communities more than 3,000 people are actively involved. The community benefits from their involvement, while they benefit from the opportunity to enhance existing skills and acquire new ones.

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We also participate in the Federated Apprentice Scheme, which offers young adults employed by SMEs in the South of England the opportunity to gain a qualification in ICT.

We have recently introduced alternatives to voluntary redundancy and the emphasis has shifted to redeployment, retraining and skills management. We have, for example, developed an innovative scheme in which BT employees are placed with other organisations to work outside BT to help develop their skills. We are working with an external recruitment agency to use their network to maximise these opportunities. As our skills requirements change, so those people can be brought back in house.

Reward and recognition

We conduct a review of salaries every year. The 2009 review took into account the current difficult economic climate, market conditions and the need to maintain a sustainable and competitive cost base. Following discussions with our trades unions, BT has advised all employees including senior executives that there will be no increases to salary in the UK arising from the 2009 review. This principle will be followed as closely as possible in all other countries in which we operate.

Around 40,000 managers are eligible for variable, performance-related bonuses. The long-term incentives for our most senior managers are linked to BT s total shareholder return performance measured over a period of three years. For Openreach senior managers, the key measure is Openreach s performance over a three-year period. For 2009, our bonus scheme was restructured to improve alignment to overall business results and affordability.

Employees outside the UK receive an annual award of free BT shares or a cash equivalent depending on local legal and/or regulatory requirements. In the UK, employees receive free broadband. Employees in more than 25 countries also have the opportunity to save to buy BT shares at a discount to the price at the start of the savings period. Under the BT Employee Share Investment Plan, UK employees can buy BT shares from their pre-tax and pre-National Insurance salaries. More than 50% of eligible employees participate in one or more of these plans.

Pensions

Most of our UK employees are members of a pension scheme, either the BT Pension Scheme (BTPS), a defined benefit scheme, or until recently, the BT Retirement Plan (BTRP), a money purchase scheme. The BTPS was closed to new members on 31 March 2001 and the BTRP on 31 March 2009.

During 2009 we conducted a review of our UK pension arrangements, including extensive consultation with the trade unions and employees. The aim was to ensure the schemes remain flexible, fair and sustainable for the long term.

Changes to future benefit accruals under the BTPS were effective from 1 April 2009. Benefits built up before 1 April 2009 remain linked to final pensionable salary. The changes include increasing the normal retirement age to 65, moving to a career average revalued earnings basis, changes to member contributions and ceasing to contract out of the State Second Pension.

The BTPS has around 64,000 active members, 181,000 pensioners and 96,000 deferred members.

The BT Retirement Saving Scheme was set up on 1 April 2009 as a successor to the BTRP and the Syntegra Limited Flexible Pensions Plan (SLFPP). It is a contract-based, defined contribution arrangement, which means that what the pension members receive is linked to contributions paid, the performance of the fund and the annuity rates at retirement, rather than their final BT salary. Former BTRP and SLFPP members are being invited to transfer their accumulated assets to this scheme. All these pension schemes are controlled by independent trustees.

We have reached agreement with the Trustee of the BTPS that deficit contributions of £525m per annum will be made in cash, or in specie, over the next three years. This agreement has been approved by the Pensions Regulator. See **Pensions** in the **Financial review** on page 42 for further details.

Flexibility and diversity

We continue to create an inclusive working environment in which employees can develop their careers regardless of their race, sex, religion/beliefs, disability, marital or civil partnership status, age, sexual orientation, gender identity, gender expression or caring responsibilities. This inclusiveness is supported by our flexible working arrangements.

Examples of diversity include the fact that 22% of our workforce is female and women hold 21% of our top 400 leadership roles. In addition, more than 10% of our most highly rewarded people in the UK are from an ethnic minority background. Our policy is for people to be paid fairly regardless of gender, ethnic origin or disability.

We work with specialist recruitment agencies to attract people with disabilities to work for BT, and in partnership with Remploy, we run a retention service to ensure that talented people can stay with us even if their capabilities change.

Outside the UK, we are working to ensure that our policies and practices are tailored to address legislation country by country, as well as respecting cultural differences.

Health and safety

The health and safety of our people are of paramount importance and we continue to seek improvements by focusing on behavioural/lifestyle change.

More detailed information on employee engagement, our health and safety performance and diversity in BT can be found in the chart on pages 24 and 25.

Employee communications

Employees are kept informed about our business through a wide range of communications channels, including our online news service, email bulletins, webchats and webcast briefings and a printed publication.

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£1.1bn
invested in R&D in 2009

We conduct a quarterly pulse survey, which focuses on key aspects of our employees experience including attitudes to team working and relationships with line managers. See chart on pages 24 and 25 for some key results. We encourage managers to discuss the results with their teams and build on any strengths identified and address any areas for improvement.

We have a record of stable industrial relations and enjoy constructive relationships with recognised unions in the UK and works councils elsewhere in Europe. In the UK, we recognise two main trade unions the Communication Workers Union and Connect. We also operate a pan-European works council, the BTECC.

Our UK network

We have the most comprehensive fixed-line communications network in the UK, with around 5,600 exchanges, 680 local and 120 trunk processor units, more than 128m kilometres of copper wire and over 11m kilometres of optical fibre, and an extensive IP backbone network.

Our global research and development capability

We have created a global research and development (R&D) capability to support BT s drive to meet customers needs around the world. We have a world-class team of researchers, scientists and developers, including people at Adastral Park near Ipswich (England), a research team based in Malaysia and a new research centre in China. We have recently established a collaborative research and innovation centre in the United Arab Emirates with the Emirates Telecommunications Corporation (Etisalat) and Khalifa University. We also play a leading role in the India-UK Advanced Technology Centre, a research consortium of industry and academic partners from India and the UK.

We have established two global development centres in the UK and India, and are currently establishing three more in Europe, the US and China. These bring all our global development teams together, and use online collaboration and videoconferencing systems for virtual joint working.

Open innovation

We embrace open innovation, reaching out beyond the company to find the best people and the best ideas, wherever they are in the world. We are involved in partnerships at every stage of the innovation process, from scientific research to the development of new products and services.

We have dedicated innovation scanning teams in the US, Asia, Europe and the Middle East who identify more than 600 new technologies, business propositions and market trends a year.

In 2009, we invested £1,119m (2008: £1,252m) in R&D to support our drive for innovation. This investment comprised capitalised software development costs of £529m (2008: £720m) and R&D operating costs of £590m (2008: £532m).

We work with more than 30 universities around the world and have key partner relationships with the University of Cambridge, University of Oxford, University College London and MIT (Massachusetts Institute of Technology).

Building on our long tradition of innovation, we filed patent applications for 120 inventions in 2009. We routinely seek patent protection in different countries including the US, Japan, France, Germany and China, and we currently maintain a total worldwide portfolio of around 7,600 patents and applications.

BUSINESS AND FINANCIAL REVIEWS BUSINESS REVIEW

Corporate responsibility

We measure progress towards our corporate responsibility (CR) goals using our non-financial KPIs, which are shown in the chart on pages 24 and 25. We also report the direct costs to BT and the indirect impacts on society associated with the way we manage environmental and social issues. This is in accordance with the principles of the Connected Reporting Framework sponsored by HRH, the Prince of Wales. Our sustainability report (**www.bt.com/betterworld**) provides full details of our CR progress.

Supporting communities

All our lines of business support our community involvement activities.

UK

In 2009, we helped to launch Communicating for Success, a co-funded partnership between BT and the Football Foundation, to tackle digital exclusion and improve communications skills in the UK.

We partner with a number of charities, including Childline, Children in Need and the Disasters Emergency Committee (DEC) in 2009, for which BT and BT employees raised over £4m. BT people volunteer to take donations in our call centres as part of major charity telephone and online appeals. We also manage the telephone networks and provide the online donation technology.

For the past three years, Openreach has supported iCAN, a charity working for children with speech and language difficulties.

Rest of the world

The Inspiring Young Minds programme, our global development partnership with UNICEF, which brings IT skills to children, launches in China in 2010, following Brazil in 2008 and South Africa in 2007. In India, we support the work of the Katha IT and E-commerce school in one of Delhi s poorest areas.

We launched our first global disaster relief secondee programme with the Red Cross. BT volunteers with critical skills can be deployed into disaster zones alongside the aid charity s own workers.

Protecting the environment

We aim to be a leader in the new low carbon economy. On the one hand, we recognise that the IT and communications industries constitute nearly 2% of global carbon emissions, and we are working hard to reduce these. On the other hand, communications technology reduces the need for people to travel and offers scope for improved logistics, energy distribution and energy management which in turn reduces carbon emissions.

We have been rated number one in the telecommunications sector in the Dow Jones Global Sustainability Index for the past eight years. We also hold the Queen s Award for Enterprise for Sustainable Development and Business in the Community s Community Mark.

We meet the guidelines of the Association of British Insurers in reporting on social performance and have also applied the Prince of Wales Accounting for Sustainability reporting framework.

Corporate responsibility risks

During 2009, we continued to develop our knowledge and understanding of our corporate responsibility risks. Our most significant CR risks continue to be:

4 breach of our code of business ethics

4 climate change

4 diversity

4 health and safety

4 privacy

4 supply chain working conditions.

Each of these risks has an owner and a mitigation strategy in place. These risks are not regarded as material in relation to the group and consequently are not included in **Principal risks and uncertainties**.

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Non-financial corporate responsibility KPIs

	Key performance indicators	Direct company impacts: Non-financial indicators			
		Target 2010	**2009**	**2008**	**2007**
Customers	**Customer service** A measure of success across BT s entire customer base	To improve customer service based on getting things right first time (RFT) in line with our corporate scorecard	**17%** improvement in RFT service from 2008	**9%** improvement in RFT service from 2007	**3%** increase in customer satisfaction (our previous measure)
	Employee engagement index A measure of the success of BT s relationship with employees, through its annual employee attitude survey	Maintain or improve the 2009 level of employee engagement. We moved to a five point scale this year, and have restated previous scores	**3.61**	**3.60**	**3.62**
Employees	**Diversity** A measure of the diversity of the BT workforce	BT will maintain a top 10 placement in four of five major diversity benchmarks. Includes four UK benchmarks and the Schneider-Ross Global Diversity benchmark (from 2008)	BT is in the top 10 placement in four out of the five major diversity benchmarks	BT is in the top 10 placement in four out of the five major diversity benchmarks	BT is in the top 10 placement in three out of four main UK diversity benchmarks
	H&S: lost time injury rate Lost time injury cases expressed as a rate per 100,000 hours worked on a 12 month rolling average	Reduce to 0.157 cases	**0.160** cases	**0.188** cases	**0.238** cases

	H&S: sickness absence rate Percentage of calendar days lost to sickness absence expressed as a 12 month rolling average	Reduce to 1.9% calendar days lost due to sickness	**2.17%**	**2.43%**	**2.43%**
	Supplier relationships A measure of the overall success of BT s relationship with suppliers, based on our annual supplier survey	To achieve a rating of 80% or more, based on the question: How would you describe the quality of your company s relationship with BT?	**85%**	**78%**	New measure in 2008
Suppliers	**Ethical trading** A measure of the application of BT s supply chain human rights standard	To achieve 100% follow up within three months for all suppliers identified as high or medium risk, through our ethical standard questionnaires	**78** risk assessments with 100% follow up	**234** risk assessments with 100% follow up	**413** risk assessments with 100% follow up
Improving society	**Community effectiveness measure** An independent evaluation of our community programme	Maintain evaluation score at over 90%	**91%**	**79%**	**70%**
	Investment to improve society	Maintain a minimum investment of 1% of underlying pre-tax profits	**1.01%**	**1.02%**	**1.05%**
Environment	**CO_2 equivalent emissions** A measure of BT s climate change	By December 2020, BT group will reduce its CO_2e emission	CO_2e 906,000 tonnes **44%** reduction	CO_2e 920,000 tonnes **43%** reduction	CO_2e 896,000 tonnes **45%** reduction

	impact	intensity by 80% against 1997 levels. New target set in 2008	**43%** intensity reduction	**52%** intensity reduction	**52%** intensity reduction
	Waste to landfill and recycling A measure of BT s use of resources	BT group will reduce the tonnage of waste sent to landfill by 8% from 2009	**17%** reduction in waste to landfill from 2008 (UK only)	**22%** reduction in waste to landfill from 2007 (UK only)	**8%** reduction in waste to landfill from 2006 (UK only)
Integrity	**Business practices measure** How our Statement of Business Practice is implemented. Measured through a regular employee survey	We plan to make this indicator more broad-ranging to include all relevant policies including our new anti-corruption and bribery, and gifts and hospitality policies	**77%**	**83%**	**87%**

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All targets have an end date of 31 March
2010 unless otherwise indicated.

Direct company impacts: Financial indicators	2009	2008	2007	Indirect company impacts
Total revenue	**£21,390m**	**£20,704m**	**£20,223m**	
Average annual revenue per (UK) consumer household	**£287**	**£274**	**£262**	
Employee costs	**£5,506m**	**£5,358m**	**£5,223m**	Employee engagement is a driver of customer satisfaction
Number of employees	**107,021**	**111,858**	**106,200**	
BT will develop a relevant financial indicator for diversity next year				Establishing a diverse workforce promotes social cohesion
Cost to the business arising from injuries resulting in time off work	**£7m**	New measure in 2009		Lowering lost days from injuries and sickness reduces societal health care costs and improves productivity
BT sick pay costs	**£85.2m**	**£89.8m**	**£84.7m**	

Total spend with suppliers	**£8.9bn**	**£8.6bn**	**£6.8bn**	Economic multiplier effect (e.g. employment) arising from BT s supply chain procurement
Value of procurement contracts where our suppliers agree that we work with them to improve sustainability impacts (extrapolated from a representative supplier survey)	**£7.4bn** (83% of supplier spend)	**£5.7bn** (66% of supplier spend)	First measured in 2008	Quality of life especially working conditions in emerging economies
Community investment (time, cash and in-kind support)	£**25.0m**	**£22.3m**	**£21.8m**	BT s community programme focuses on improving communication and ICT skills. This helps improve people s employment prospects and increase social inclusion
Total energy costs (fleet fuel + gas + oil + diesel for back up generators etc; UK and Ireland only)	**£227m**	**£194m**	**£185m**	Indirect negative impacts occur in the manufacture of equipment and through energy consumption in customer premises. Positive impacts arise from application of ICT to support low-carbon economy
Income from recycling	**£7.42m**	**£6.70m**	**£4.48m**	Dealing with end of life products sold into the market place. Acting to reduce obsolescence
Landfill tax savings	**£1.15m**	**£0.89m**	**£0.84m**	
Waste costs	**£(7.90)m**	**£(7.27)m**	**£(5.15)m**	
Net waste savings	**£0.67m**	**£0.32m**	**£0.17m**	
Revenue Support	**£1.9bn**	**£2.2bn**	**£1.8bn**	A responsible business culture, banning corrupt practices including facilitation

(customer bids with a sustainability component)	payments, supports better international governance

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OTHER MATTERS

Regulation

BT operates in a dynamic and competitive environment both in the UK and around the world. Innovation is accelerating, driven by customer demand. Products and services are evolving and converging, supported by increasingly sophisticated networks. Service bundles offering fixed and mobile telephony, broadband and television are available from an increasing number of suppliers.

We believe that, in such a climate, regulation must deliver a level playing field in the UK which allows companies across the fast-moving and converging markets to compete on equal terms, and makes sure that new monopolies are not allowed to emerge. We also need regulation to move at the same speed as the market is evolving such that regulation is only applied where necessary. Otherwise, there is a real risk that innovation and investment could be stifled.

Regulation in the UK

Electronic communications regulation in the UK is conducted within a framework set out in various European Union (EU) directives, regulations and recommendations. The framework is currently under review and new directives are expected to take effect by 2011.

Ofcom

Ofcom (the Office of Communications) was set up under the Office of Communications Act 2002 to provide a single, seamless approach to regulating the entire 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 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 communications providers (CPs) authorised to carry out streetworks and similar activities for network provision. It requires electronic CPs with apparatus on or in the public highway to make financial provision to cover any damage caused by work they carry out, and for the removal of their networks in the event of liquidation or bankruptcy. This has been provided for the period to 31 March 2010.

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 Kingston Communications 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.

Ofcom is scheduled to conduct a review of the narrowband USO in 2009, including whether it is still appropriate for BT to bear the entire cost of meeting the USO or whether there should be some contribution from the broader industry.

It should also be noted that in its Digital Britain interim report (January 2009), the UK Government set out its objective to develop plans for commitments around universal service covering broadband services to be effective by 2012. We are working closely with the UK Government, Ofcom and the wider communications industry on these plans, which we expect will be published more fully in the summer of 2009.

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. At 31 March 2009, as a result of previous market reviews, BT was deemed to have SMP in a number of markets.

However, Ofcom is in the process of consulting on SMP designations in both the retail and wholesale narrowband services markets. Its review of fixed narrowband retail services relates in particular to the supply of consumer and business telephone lines and voice calls. In the course of this review, Ofcom has proposed that BT no longer has SMP in these markets and that if Ofcom finalises its proposals, this would result in BT having greater freedom to package and price those services as we choose.

Ofcom is also currently reviewing wholesale narrowband services markets. It has proposed that while BT will retain SMP in certain defined markets for example, the provision of wholesale exchange lines, call origination and interconnect links in other markets, such as local-to-tandem conveyance and single tandem transit, SMP would be removed and BT s activities deregulated.

Ofcom s consultation on both the retail and wholesale narrowband services market review will close on 28 May 2009 and Ofcom will issue a statement later in the year setting out its conclusions.

In May 2008, Ofcom removed BT s SMP designation in relation to the provision of wholesale broadband access services in defined geographic areas of the UK (defined as Market 3). This followed Ofcom s finding that effective competition in the provision of broadband in these areas had resulted from cable companies and CPs purchasing unbundled local loops from Openreach. All previous regulation of BT s wholesale activities in relation to broadband services in these areas was therefore removed.

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Significant market power charge controls

As a result of SMP designations, the charges we can make for a number of wholesale services are subject to the following regulatory controls:

4 network charge controls (NCC) on wholesale interconnect services we operate under interconnection agreements with most other CPs. Our charges for interconnect services are controlled by Ofcom, under the NCC regime. These controls are designed to ensure that our charges are reasonably derived from costs, plus an appropriate return on capital employed. Ofcom is currently reviewing the charge control to take effect for four years from 1 October 2009 and is consulting on a range of options where charges would be allowed to increase by more than inflation

4 partial private circuits (PPC) charge controls applying to certain wholesale leased lines that BT provides to other network operators. Ofcom has consulted on proposals for new controls to apply from 1 October 2009 and is expected to issue its final decision in the first quarter of the 2010 financial year

4 Ofcom is proposing to introduce charge controls on BT s provision of wholesale Ethernet access and backhaul services at bandwidths of 1Gb or below from 1 October 2009. Again, Ofcom s final decision on these controls is expected in the first quarter of the 2010 financial year

4 Ofcom has also been consulting on regulatory controls governing the charges Openreach applies to the provision of local loop unbundling (LLU) services and wholesale line rental (WLR). Ofcom is expected to publish a statement shortly setting out its conclusions on LLU charges and issue a further consultation on WLR charges.

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. This, in itself, should lead to a reduction in the need for regulation in those competitive downstream markets over time.

BT is in discussion with Ofcom and the wider communications industry about the remaining Undertakings in the context of changing industry priorities and systems capacity. Any proposed changes will be subject to consultation during the 2009 calendar year.

Next generation access regulation

In March 2009, following consultation, Ofcom published a policy statement setting out a regulatory framework for next generation access (NGA). This gave sufficient regulatory certainty for BT to proceed with the initial phase of our super-fast broadband roll out and we will continue to work with Ofcom as our plans develop.

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 European Regulators Group to introduce greater harmonisation in their approach to the assessment of SMP and the imposition of appropriate remedies.

BT does not have universal service obligations outside the UK, although in certain member states we may be required to contribute towards an industry fund to pay for the cost of meeting such obligations.

The European Commission formally investigated the way the UK Government set BT s property rates and those paid by Kingston Communications, and whether or not the UK Government complied with European Community Treaty rules on state aid. It concluded that no state aid had been granted. The Commission s decision has now been appealed, but we continue to believe that any allegation of state aid is groundless, and that the appeal will not succeed.

The rest of the world

The vast majority of the communications markets in which we operate around the world are subject to regulation, and in most of these we have to meet certain conditions and have had to obtain licences or other authorisations. The degree to which these markets are liberalised varies widely, which means that our ability to compete fully in some countries is constrained. We continue to press incumbent operators and their national regulatory authorities around the world (including in the EU) for cost-related 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

UK market trends

Broadband take up in the UK is slowing as the market matures and reaches high levels of penetration. However, usage is growing, driven for example by the increased popularity of peer-to-peer applications and of services such as the BBC iPlayer and BT Vision. Mobile broadband has also been a focus for many of the mobile operators as the voice and text markets approach saturation. Broadband providers are now expected to deliver an excellent level of service in addition to a range of applications and products tailored to the individual needs of customers.

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Competition law

In addition to communications industry-specific regulation, BT is subject to the Competition Act 1998 (Competition Act) in the UK and to EU competition law. Where we operate outside the UK, we are also subject to the competition laws in the relevant countries.

In 2004, Ofcom launched an investigation into allegations that BT had abused a dominant position in relation to its pricing of consumer broadband products. Ofcom sent BT three statements of objection to which we responded and argued that our pricing does not amount to an abuse of dominance. Ofcom is expected to issue a decision in due course.

Branches outside the UK

BT operates branches outside the UK in Europe, the Middle East, Africa, the Americas and the Asia Pacific region.

Our relationship with HM Government

The UK Government, collectively, is our 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 below, the commercial relationship between BT as a supplier and the UK Government as a customer has been on a normal customer and supplier basis.

We can, however, be required by law to do certain things and provide certain services for the UK Government. General conditions made under the Communications Act require all providers of public telephone networks and/or publicly available telephone services, including BT, at the request of and in consultation with the authorities, to make, and if necessary implement, plans for the provision or restoration of services in connection with disasters. The Civil Contingencies Act 2004 contains provisions enabling the UK Government to impose obligations on providers of public electronic communications networks, including BT, at times of emergency and in connection with civil contingency planning. In addition, the Secretary of State has statutory powers to require us to take certain actions in the interest of national security and international relations.

Legal proceedings

We do not believe that there are any pending legal proceedings that would have a material adverse effect on the financial position or operations of the group. There have been criminal proceedings in Italy against 21 defendants, including a former BT employee, in connection with the Italian UMTS (universal mobile telecommunication system) auction in 2000. Blu, in which we held a minority interest, participated in that auction process. On 20 July 2005, the former BT employee was found not culpable of the fraud charge brought by the Rome Public Prosecutor. All the other defendants were also acquitted. The Public Prosecutor has appealed the court s decision. If the appeal is successful, BT could be held liable, with others, for any damages. The company has concluded that it would not be appropriate to make a provision in respect of any such claim.

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.

2009

During the 2009 financial year, we completed a number of acquisitions:

Date	Acquisition
May 2008	Wire One Holdings Inc one of the leading providers of videoconferencing solutions in the US. Wire One is central to BT Conferencing s video business unit, extending its customer footprint and enhancing its videoconferencing capabilities.

July 2008	Ufindus Ltd, one of the UK s leading online business directories. The acquisition from Iomart Group plc underpins the continued growth of BT Directories, our classified advertising and directories business.
July 2008	Ribbit Corporation, a Silicon Valley-based Telco 2.0 platform company for $105m. The acquisition will accelerate our transformation into a next generation, platform-based, software-driven services company. In addition, it complements our existing capability in software development platforms. The integration of Ribbit with 21CN progressed well during the year.
July 2008	Stemmer GmbH and SND GmbH, two German companies constituting the enterprise IT services segment of net AG, listed on the Frankfurt Stock Exchange. The acquisitions strengthen our skills and capabilities in the German market, in line with our strategy to offer networked IT services to our corporate customers in Germany and globally.

We also completed a number of other transactions in 2009, including:

4 an agreement with Sekunjalo Investments Ltd, under which Sekunjalo has become a 30% shareholder in BT s South African business

4 an extension of the geographic scope of our joint venture with Enìa SpA in Parma, Italy and an increase of our stake in the joint venture from 55% to 59.5%

4 the acquisition of the remaining shares of Net2S SA, a publicly traded IT services company listed in France, other than certain treasury shares and locked-up shares issued under employee share plans (we had acquired over 91% of the outstanding issued share capital of Net2S SA in 2008).

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Prior to 2009

The BT of today was largely created by a radical restructuring of the company in the 2002 financial year. This restructuring involved a rights issue (raising £5.9bn), the demerger of O_2 (comprising BT s wholly owned mobile assets in Europe), the disposal of significant non-core businesses and assets, the unwinding of Concert (our joint venture with AT&T) and the creation of customer-focused lines of business.

In 2007, we completed a number of acquisitions, including:

4 dabs.com (an online retailer of IT and technology products)

4 PlusNet (an internet service provider)

4 International Network Services (INS) (the California-based global provider of IT consulting and software solutions).

In 2008, our acquisitions included:

4 i2i Enterprise Pvt Ltd (a Mumbai-based company which specialises in IP communications services for major Indian and global multinational companies)

4 Comsat International (a provider of data communications services for corporations and public sector organisations in Latin America)

4 the IT infrastructure division of CS Communication & Systèmes (the French IT systems and network services provider)

4 Frontline Technologies Corporation Ltd (one of the leading providers of end-to-end IT services in the Asia Pacific region).

We also completed the merger of I.NET SpA, an Italian data services provider with BT Italia SpA (formerly Albacom).

Our property portfolio

At 31 March 2009, we occupied approximately 7,000 properties in the UK and approximately 400 properties in the rest of the world. The majority of the UK properties are owned by and leased from the Telereal Group, which is part of the William Pears Group. Approximately 85% 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.

Our group property team manages waste and recycling on behalf of the rest of the business. More detailed information on waste management and recycling can be found in the chart on pages 24 to 25.

Principal risks and uncertainties

In common with all businesses, BT is affected by a number of risks and uncertainties, not all of which are wholly within our control. Although many of the risks and uncertainties influencing our performance are macroeconomic and likely to affect the performance of businesses generally, others are particular to our operations.

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. Some may be unknown to us and others, currently regarded as immaterial, could turn out to be material. All of them have the potential to impact our business, revenue, profits, assets, liquidity and capital resources adversely.

We have a defined enterprise wide risk management process for identifying, evaluating and managing the significant risks faced by the group. The key features of the risk management process are provided in the statement on

Internal control and risk management on page 72 . The group risk register captures the most significant risks facing the business. Each risk is assigned a senior management owner responsible for monitoring and evaluating the risk and the mitigation strategies.

In the 2008 Annual Report & Form 20-F, we highlighted Transformation Strategy and Technological Advances as principal risks. These are not included for 2009 because the group s transformation programme was completed during the first half of the year. In addition, as the new 21CN core network has now been completed, any ongoing risks associated with general technological advances are managed as part of the group s normal risk management process. Ongoing risks associated with the general competitive environment are set out below.

The principal risks and uncertainties should be considered in conjunction with the risk management process, the forward looking statements in this document and the **Cautionary statement regarding forward looking statements** on page 148.

Competitive activity

We operate in highly competitive markets where customers can switch suppliers based on price and service levels as well as competitor activity. The profitability of these markets is declining as the competitive intensity and volatility of these markets increases.

Factors contributing to levels of competitive activity include resource rich competitors from adjacent markets entering our markets; competitors emerging with radically different costs bases, capabilities, propositions and/or business models; the emergence of new technologies and products offering increased performance at lower cost; decline in market growth rates and profitability due to the current economic environment; increased levels of customer churn and reduced levels of market differentiation.

Global economic and credit market conditions

A general reduction in business activity resulting from the current economic downturn in the global economy could lead to a loss of revenue and profits for us. Our business performance could also be adversely affected by increased exposure to the default of customers and suppliers as economic conditions worsen. In addition the impact of the current credit market conditions potentially impacts our ability to access liquidity in the capital markets and increases the risk of a counterparty exposure should any counterparty default on its contractual obligations. Volatility in the currency markets also affects our revenues and costs and while appropriate actions are taken to mitigate this risk there remains ongoing exposure to foreign exchange movements.

BUSINESS AND FINANCIAL REVIEWS OTHER MATTERS

If economic and credit conditions do not improve, we may not be able to generate sufficient cash flow, or access capital markets, to enable us to service or repay our indebtedness or to fund our other liquidity requirements. We may be required to refinance all or a portion of our indebtedness on or before maturity, reduce or delay capital expenditure or seek additional capital. Refinancing or additional financing may not be available on commercially reasonable terms, or at all. Our inability to generate sufficient cash flow to satisfy our debt service obligations, or to refinance debt on commercially reasonable terms, may adversely affect our business, financial condition, results of operations and prospects.

We expect the current economic conditions to continue for some time and we will continue to seek to mitigate the risks that arise while identifying and exploring opportunities.

Regulatory controls

Some of our activities are subject to significant price and other regulatory controls which may affect our market share, competitive position and future profitability.

Most of our wholesale fixed-network activities in the UK are subject to significant regulatory controls. The controls regulate, among other things, the prices we may 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 some of these controls has been to require us to reduce our prices. We cannot provide assurance to our shareholders that the regulatory authorities will not increase the severity of the price controls, extend the services to which controls apply (including any new services that we may offer in the future), or extend the services which we have to provide to other CPs. These controls may adversely affect our market share and our future profitability.

In response to Ofcom s strategic review of telecommunications, we proposed a number of legally binding Undertakings that were accepted by Ofcom and came into force in September 2005. A number of challenging milestones in the Undertakings also remain to be delivered.

In the case of a breach of the Undertakings, Ofcom has the right to seek an injunction through the courts or issue a direction. Third parties who suffer losses as a result of a breach may also take action against BT in the courts for damages. The timescales for achievement of a number of the milestones in the Undertakings are very challenging and we are in consultation with Ofcom and the wider communications industry about the remaining Undertakings in the context of changing industry priorities and systems capacity.

Ofcom is conducting a number of reviews which are expected to be completed during the 2010 financial year. These include review of the wholesale narrowband market, the Openreach financial framework, the wholesale line rental charge control, and the wholesale local access market. Whilst these reviews are, in our view, an opportunity to create regulatory stability, there is a risk that they may adversely affect our competitive position and future returns on our regulated copper asset base.

Further details on the regulatory framework in which we operate can be found in **Regulation** on pages 26 to 27.

Major contracts

Our business may be adversely affected if we fail to perform on major customer contracts.

We have entered into a number of complex and high value networked IT services contracts with customers, increasingly won in areas which are competitive. Our pricing, cost and profitability estimates for major contracts generally include anticipated long-term cost savings that we expect to achieve over the life of the contract.

These estimates are based on our best judgement of the efficiencies we expect to achieve. Any increased or unexpected costs, failures to achieve the anticipated cost savings, or unanticipated delays, including delays caused by factors outside our control, could make these contracts less profitable or even loss making, so adversely impacting our profit margins. The degree of risk increases generally in proportion to the scope and life of the contract and is typically higher in the early stages. Some customer contracts require significant investment in the early stages which is recoverable over the life of the contract.

In 2009, a failure to achieve anticipated cost savings made a number of our major contracts less profitable or even loss making, adversely impacting our profits. Contract and financial reviews were undertaken in BT Global Services, and resulted in a more cautious view of the recognition of future cost efficiencies and other changes in underlying assumptions and estimates particularly in light of the current economic outlook, resulting in significant contract and financial review charges being recognised. For more detail, see page 10.

In addition, major contracts often involve the implementation of new systems and communications networks, transformation of legacy networks and the development of new technologies. 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. There can be delays in these phases and certain milestones may be missed which could adversely impact our profit margins and the recoverability of any capitalised contract costs. In some cases, our products and services incorporate software or system requirements from other suppliers or service providers, and failure to meet these obligations may in turn impact our ability to meet our commitments in a timely manner. Failure to manage and meet our commitments under these contracts may lead to a reduction in our future revenue, profitability and cash generation.

We may lose significant customers due to merger or acquisition, business failure or contract expiry. Failure to replace the revenue and earnings from lost customers could reduce revenue and profitability.

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Security and resilience

We are critically dependant on the secure operation and resilience of our information systems, networks and data.

Any significant failure or interruption of data transfer as a result of factors outside our control could have a material adverse effect on the business and our results from operations. We have a corporate resilience strategy and business continuity plans in place, designed to deal with such catastrophic events including, for example, major terrorist action, industrial action, extreme computer virus attack, hurricane or flooding. A failure to deliver that strategy may lead to a reduction in our profitability and there can be no assurance that material adverse events will not occur.

The scale of our business and global nature of our operations means we are required to manage significant volumes of personal and sensitive information. We also store and transmit data for our customers all of which needs to be safeguarded from potential exposure and therefore requires a high level of management and security.

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 defined benefit pension scheme (BTPS) becoming a significant burden on our financial resources. Whilst the triennial actuarial funding valuation as at 31 December 2008 has not yet been completed, as detailed on page 43, BT and the Trustee of the BTPS have agreed that deficit contributions of £525m per annum will be made over the next three years. This agreement has been approved by the Pensions Regulator.

The results of future scheme valuations and associated funding requirements will be impacted by the future performance of investment markets, interest and inflation rates and the general trend towards longer life expectancy, as well as regulatory changes, all of which are outside our control.

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FINANCIAL REVIEW
The following table shows the summarised group income statement.

Summarised group income statement

Year ended 31 March	2009 £m	2008 £m	2007 £m
Revenue	21,390	20,704	20,223
Other operating income[a]	339	349	233
Operating costs[a]	(21,318)	(18,697)	(17,915)
Operating profit			
Before specific items[b]	819	2,895	2,713
Specific items	(408)	(539)	(172)
	411	**2,356**	**2,541**
Net finance expense			
Before specific items[b]	(620)	(378)	(233)
Specific items			139
	(620)	**(378)**	**(94)**
Share of post tax profits (losses) of associates and joint ventures			
Before specific items[b]	39	(11)	15
Specific items	36		
	75	**(11)**	**15**
Profit on disposal of associates and joint ventures specific items		9	22
(Loss) profit before taxation			
Before specific items[b]	238	2,506	2,495
Specific items	(372)	(530)	(11)
	(134)	**1,976**	**2,484**
Taxation			
Before specific items[b]	10	(581)	(611)
Specific items	43	343	979
	53	**(238)**	**368**
(Loss) profit for the year			
Before specific items[b]	248	1,925	1,884
Specific items	(329)	(187)	968
	(81)	**1,738**	**2,852**
Basic (loss) earnings per share			
Before specific items[b]	3.2p	23.9p	22.7p

Specific items	(4.3)p	(2.4)p	11.7p
Total basic (loss) earnings per share	**(1.1)p**	**21.5p**	**34.4p**

[a] Includes specific items.

[b] Operating profit before specific items, net finance expense before specific items, share of post tax profits (losses) of associates and joint ventures before specific items, (loss) profit before taxation and specific items, taxation before specific items, (loss) profit for the year before specific items and basic (loss) earnings per share before specific items are non-GAAP measures provided in addition to the disclosure requirements defined under IFRS. The rationale for using non-GAAP measures is explained on pages 33, 47 and 48.

The following table reconciles (loss) profit before taxation to adjusted profit before taxation[c], an additional non-GAAP measure used in 2009.

(Loss) profit before taxation	(134)	1,976	2,484
Contract and financial review charges	1,639		

Specific items	372	530	11
Adjusted profit before taxation[c]	1,877	2,506	2,495
Adjusted basic earnings per share[c]	18.4p	23.9p	22.7p

[c] Adjusted results refer to the results before the contract and financial review charges recorded within BT Global Services and specific items and are non-GAAP measures provided in addition to the disclosure requirements defined under IFRS. The rationale for using non-GAAP measures is explained on pages 33, 47 and 48.

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BUSINESS AND FINANCIAL REVIEWS FINANCIAL REVIEW
Revenue by product year ended 31 March (£m)

Introduction to the Financial review
In the Financial review we discuss the results of the group for 2009, 2008 and 2007. We explain the performance of the business using a variety of measures, some of which are not explicitly defined under IFRS, and are therefore termed non-GAAP measures . These measures are in addition to, and supplement, those prepared in accordance with IFRS. In particular, in this Financial review, we principally discuss the group s results on an adjusted basis. Results on an adjusted basis are presented before the contract and financial review charges recorded within BT Global Services and specific items. Further discussion of the BT Global Services contract and financial review charges is given on page 10. In our income statement we separately identify specific items and present our results both before and after these items. This is consistent with the way that financial performance is measured by management and assists in providing a meaningful analysis of our results. The directors believe that presentation of the group s trading results in this way is relevant to an understanding of the group s performance as specific items are significant one-off or unusual in nature and have little predictive value. Specific items are therefore analysed and discussed separately in this Financial review. The other non-GAAP measures we use in this Financial review are underlying revenue, underlying operating costs, free cash flow and net debt.

Each of these measures is discussed in more detail at the end of this section, on pages 47 and 48.

In the Financial review, references we make to 2009 , 2008 , and 2007 are to the financial years ended 31 March 2009, 2008 and 2007, respectively. References to the year and the current year are to the year ended 31 March 2009.

Line of business results

The financial performance of the lines of business for 2009, 2008 and 2007 are discussed in the Business review. We measure the financial performance of BT Retail, BT Wholesale and Openreach based on EBITDA and operating profit before specific items. For 2009 we measure the results of BT Global Services on an adjusted basis, being before the impact of contract and financial review charges and specific items. For further discussion of these items, see pages 47 to 48. A reconciliation of adjusted EBITDA to group operating profit (loss) by line of business, and for the group, is provided in the table at the foot of pages 34 to 35.

	Internal cost recorded by					
	BT Global Services £m	BT Retail £m	BT Wholesale £m	Openreach £m	Other £m	Total £m
Internal revenue recorded by:						
BT Global Services						
BT Retail	219		51	4	85	359
BT Wholesale				1,228		1,228
Openreach		2,250	85		1,918	4,253
Total	**219**	**2,250**	**136**	**1,232**	**2,003**	**5,840**

The table above analyses the trading relationships between each of the lines of business for 2009. The majority of the internal trading relates to Openreach and arises on rentals, and any associated connection or migration charges, of the UK access lines and other network products to the customer-facing lines of business, both directly, and also indirectly through BT Operate which is included within Other in the table above. Internal revenue arising in BT Retail relates primarily to BT Ireland and Enterprises. Internal revenue arising in BT Wholesale relates to the sale of line cards and access electronic services to Openreach.

Group results

Group revenue

Revenue increased by 3% to £21,390m. This compares with growth of 2% in 2008 and 4% in 2007. Foreign exchange movements and the impact of acquisitions contributed £653m and £521m, respectively, to revenue growth in the year. Excluding these, underlying revenue decreased by 2% in 2009, compared with group revenue in 2008.

Underlying revenue

	2009 £m
Group revenue	**21,390**
Foreign exchange movements	(653)
Acquisitions	(521)
Underlying revenue[a]	**20,216**

[a] Underlying revenue is a new non-GAAP measure used by the group for the first time in 2009. This measure is discussed in more detail at the end of this section on page 47.

Product revenue

	2009 £m	2008 £m	2007 £m
Revenue by product			
Managed solutions	6,365	5,320	4,825
Broadband and convergence	2,637	2,567	2,310
Calls and lines	6,305	6,818	7,098
Transit, conveyance, interconnect services, WLR, global carrier and other wholesale products	3,301	3,398	3,452
Other	2,782	2,601	2,538
Group total	**21,390**	**20,704**	**20,223**

Managed solutions revenue, including MPLS and networked IT services, increased by 20% to £6,365m, mainly due to the impact of foreign exchange movements on networked IT services revenue and an increase in BT Wholesale managed network solutions revenue arising from new contracts in 2009. In 2008, managed solutions revenue increased by 10%, driven by growth in revenue

BUSINESS AND FINANCIAL REVIEWS FINANCIAL REVIEW
Revenue by customer segment year ended 31 March 2009 (%)

from networked IT services and MPLS. Broadband and convergence revenue increased by 3% to £2,637m due to an increase in business mobility volumes and revenue from BT Vision. In 2008, broadband and convergence revenue increased by 11%, driven by growth in revenue from consumer broadband. These increases were partially offset by an 8% decrease in revenue from calls and lines to £6,305m, compared with a decline of 4% in 2008. The acceleration of the decline in 2009 reflects the increasingly competitive environment and further market declines. Revenue from transit, conveyance, interconnect circuits, WLR, global carrier and other wholesale products decreased by 3% to £3,301m, compared with a decrease of 2% in 2008 as a result of the continued decline in low margin transit revenue and conveyance volumes.
Customer segment revenue

Customer segment	Source of revenue
Major corporate	BT Global Services major corporate customers
Business	BT Retail s SME customers
Consumer	BT Retail s consumer customers
Wholesale/carrier	Openreach s external customers, BT Wholesale s external customers and BT Global Services global carrier customers

The group also analyses revenue by customer segment. The table above indicates the source of revenue for each of the customer segments and how this relates to the different lines of business.

	2009 £m	2008 £m	2007 £m
Revenue by customer segment			
Major corporate	8,463	7,573	7,089
Business	2,631	2,590	2,456
Consumer	4,850	5,071	5,124
Wholesale/carrier	5,404	5,442	5,537
Other	42	28	17
Group total	**21,390**	**20,704**	**20,223**

Major corporate
Major corporate revenue increased by 12% to £8,463m (2008: £7,573m, 2007: £7,089m), compared with an increase of 7% in 2008. The increase in 2009 primarily reflects the favourable impact of foreign exchange movements and recent acquisitions. BT Global Services, which serves major corporate customers, achieved total contract wins of £8.0bn in 2009 (2008: £8.0bn, 2007: £9.3bn).
Business
Business revenue increased by 2% to £2,631m in 2009 (2008: £2,590m, 2007: £2,456m), compared with growth of 5% in 2008. The increase is due to growth in mobility and convergence revenue and networked IT services revenue. The significant growth in the prior year was due to the acquisitions of Basilica and Lynx Technology.
Consumer
Consumer revenue decreased by 4% to £4,850m in 2009 (2008: £5,071m, 2007: £5,124m), compared with a decrease of 1% in 2008, due to a decline in revenue from calls and lines, which was partially offset by growth in mobility and

convergence revenue. Residential broadband connections increased by 9% to 3.6m at 31 March 2009. At 31 March 2009, we had 14m call package customers (2008: 15m). The proportion of our consumer revenue under contract was 71% in 2009, compared with 70% in 2008 and 68% in 2007.

The 12 month rolling average annual revenue per consumer household (ARPU), net of mobile termination charges, was £287 in 2009 (2008: £274, 2007: £262), a year on year increase of 5% in both 2009 and 2008. The increase to consumer ARPU reflects the higher number of customers buying multiple services from BT, together with the successful retention of higher value customers.

Line of business results

	Revenue			Operating profit (loss)[a]			Contract and financial review charges and specific items		
	2009	2008	2007	**2009**	2008	2007	**2009**	2008	2007
	£m	£m	£m	**£m**	£m	£m	**£m**	£m	£m
BT Global Services	**8,828**	7,889	7,312	**(2,106)**	117	70	**1,639**		
BT Retail	**8,471**	8,477	8,346	**1,209**	1,050	912			
BT Wholesale	**4,658**	4,959	5,386	**580**	502	592			
Openreach	**5,231**	5,266	5,223	**1,218**	1,222	1,220			
Other	**42**	28	17	**(490)**	(535)	(253)	**408**[c]	539[c]	172[c]
Intra-group	**(5,840)**	(5,915)	(6,061)						
Group totals	**21,390**	**20,704**	**20,223**	**411**	**2,356**	**2,541**	**2,047**	**539**	**172**

[a] A reconciliation from total operating profit (loss) to (loss) profit after tax is given on page 32.

[b] Items presented as adjusted are stated before contract and financial review charges recorded within BT Global Services and specific items.

[c] Specific items for all years presented.

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Wholesale and carrier

Wholesale and carrier revenue decreased by 0.7% to £5,404m in 2009 (2008: £5,442m, 2007: £5,537m), compared with a decline of 2% in 2008, as a result of a decline in low margin transit revenue, conveyance volumes and revenue from DSL broadband. The declines were partially offset by higher revenue from LLU, managed network solutions and the global carrier business.

In the UK, we had 13.8m wholesale broadband DSL and LLU connections, including 5.7m LLU lines, at 31 March 2009, an increase of 1.1m connections in the year.

Other operating income

Other operating income before specific items was £352m in 2009 (2008: £359m, 2007: £236m). The decrease in 2009 was largely due to lower income from the sale of intellectual property rights, licences, vehicles and other assets, partially offset by higher income from the sale of scrap and cable recovery. The increase in 2008 was largely due to growth in the third party business undertaken by our vehicle fleet operations, some upfront benefits from the transformation of our operational cost base through global sourcing and income from the exploitation of our intellectual property.

Operating costs

	2009 £m	2008 £m	2007 £m
Staff costs before leaver costs	5,302	5,231	5,076
Leaver costs	204	127	147
Staff costs	5,506	5,358	5,223
Own work capitalised	(673)	(724)	(718)
Net staff costs	4,833	4,634	4,505
Depreciation	2,249	2,410	2,536
Amortisation	641	479	384
Payments to telecommunications operators	4,266	4,237	4,162
Other operating costs	8,934	6,408	6,159
Operating costs before specific items	20,923	18,168	17,746
Specific items	395	529	169
Operating costs	**21,318**	**18,697**	**17,915**

Group operating costs before specific items increased by 15% to £20,923m. Group operating costs in 2009 include the impact of foreign exchange rate movements of £720m and the impact of acquisitions of £486m. Excluding these, the impact of the contract and financial review charges within BT Global Services of £1.6bn (see page 10) and specific items, underlying operating costs of £18,119m were broadly unchanged compared with the prior year. Outside of BT Global Services the rest of the group has reduced operating costs. Group operating costs before depreciation, amortisation and leaver costs, excluding BT Global Services costs of £8,562m, decreased by 6% to £7,669m, or 9% on an underlying basis excluding foreign exchange rate movements of £86m and acquisitions of £143m. The reduction reflects the success of the group s cost savings initiatives. The group has reduced total labour resource by around 15,000 in 2009. Most of the reductions were in the area of indirect labour, including agency and contractors.

Adjusted operating profit (loss)[b] 2009 £m	2008 £m	2007 £m	Depreciation and amortisation 2009 £m	2008 £m	2007 £m	Adjusted EBITDA[b] 2009 £m	2008 £m	2007 £m	
(467)	117	70	776	744	665	309	861	735	BT Global Services
1,209	1,050	912	425	445	445	1,634	1,495	1,357	BT Retail
580	502	592	686	893	908	1,266	1,395	1,500	BT Wholesale
1,218	1,222	1,220	778	689	707	1,996	1,911	1,927	Openreach
(82)	4	(81)	225	118	195	143	122	114	Other
									Intra-group
2,458	**2,895**	**2,713**	**2,890**	**2,889**	**2,920**	**5,348**	**5,784**	**5,633**	**Group totals**

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	2009 £m	2008 £m	2007 £m
Staff costs			
Wages and salaries	4,499	4,242	4,099
Social security costs	432	417	388
Pensions costs	544	626	643
Share based payments	31	73	93
	5,506	**5,358**	**5,223**

Staff costs increased by 3% to £5,506m (2008: 3%), largely due to recent acquisitions and the impact of pay inflation partly offset by cost savings. Leaver costs were £204m (2008: £127m, 2007: £147m). The pension charge for 2009 was £544m, compared with £626m in 2008 and £643m in 2007. This included £451m in respect of the BTPS, the group s main defined benefit pension scheme (2008: £561m, 2007: £594m). The decrease in pension costs in the year reflects the impact of the higher discount rate (6.85%) compared with 2008 (5.35%) on the defined benefit service cost, which was partially offset by an increase in costs associated with the group s defined contribution schemes as the membership of these schemes grows. The decrease in pension costs in 2008 reflected the impact of leavers from the BTPS, also offset by higher costs on the group s defined contribution schemes. Share based payment costs decreased by 58% to £31m, compared with a decrease of 22% in 2008, reflecting the lower fair value of new grants in 2009 and the significant number of UK Sharesave forfeitures in the year.

Depreciation and amortisation was broadly flat in 2009, compared with a decrease of 1% in 2008. This reflects higher depreciation and amortisation on 21CN assets as they are brought into use, offset by lower depreciation on legacy assets. The reduction in 2008 was largely as a result of certain legacy assets becoming fully depreciated and the useful lives of other assets being extended, which was only partially offset by higher depreciation on 21CN assets.

Payments to other telecommunication operators increased by 1% to £4,266m, compared with an increase of 2% in 2008, reflecting the impact of foreign exchange rate movements, partially offset by the impact of lower volumes. The increase in 2008 was due to higher volumes in the year. Other operating costs before specific items increased by 39% to £8,934m, largely reflecting the impact of contract and financial review charges within BT Global Services of £1.6bn, the adverse impact of foreign exchange movements, the impact of acquisitions and the slow delivery of cost efficiency savings within BT Global Services. In 2008, other operating costs increased by 4%, reflecting the impact of acquisitions, the cost of supporting networked IT services contracts and increased levels of activity in the network. Other operating costs include the maintenance and support of the networks, accommodation, sales and marketing costs, research and development and general overheads.

EBITDA

In 2009, adjusted EBITDA was £5,348m, compared with £5,784m in 2008 and £5,633m in 2007. The decline in 2009 reflects the unacceptable performance in BT Global Services and continued EBITDA decline in BT Wholesale, partially offset by a good performance in BT Retail and Openreach. The increase in adjusted EBITDA in 2008 reflected growth in the business and additional other operating income generated in the year. Including the impact of contract and financial review charges and specific items EBITDA was £3,301m in 2009, compared with £5,245m in 2008 and £5,461m in 2007.

Operating profit

In 2009, adjusted operating profit was £2,458m (2008: £2,895m, 2007: £2,713m), 15% lower than 2008, which in turn was 7% higher than 2007. The reduction in the current year reflects the unacceptable performance in BT Global Services, partially offset by good performance in the other lines of business. The increase in 2008 reflected the revenue growth of the business and the additional other operating income generated in the year. Reported operating profit was £411m in 2009, compared with £2,356m in 2008 and £2,541m in 2007.

Other group items

Specific items

Specific items for 2009, 2008 and 2007 are shown in the table on page 37, and are defined on page 33.

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	2009 £m	2008 £m	2007 £m
Other operating income			
Net loss on sale of group undertakings	13	10	5
Profit on sale of non current asset investments			(2)
	13	**10**	**3**
Operating costs			
BT Global Services restructuring charges			
Networks and products rationalisation	183		
People and property	51		
Intangible asset impairments	46		
Group restructuring charges	65	402	
21CN asset impairment and related charges	50		
Property rationalisation costs			64
Creation of Openreach and delivery of the Undertakings		53	30
Write off of circuit inventory and other working capital balances		74	65
Costs associated with settlement of open tax years			10
	395	**529**	**169**
Finance income			
Interest on settlement of open tax years			(139)
Associates and joint ventures			
Reassessment of carrying value of associate	(36)		
Profit on sale of associate		(9)	(22)
Net specific items charge before tax	**372**	**530**	**11**
Tax credit in respect of settlement of open tax years		(40)	(938)
Tax credit on re-measurement of deferred taxes		(154)	
Tax credit on specific items above	(43)	(149)	(41)
Net specific items charge (credit) after tax	**329**	**187**	**(968)**

The specific items recognised in 2009 are set out below.

4 A loss on disposal of £13m (2008: £10m, 2007: £5m) arose from the disposal of a business. The £10m and £5m losses in 2008 and 2007, respectively, relate principally to the disposal of the group s satellite broadcast business.

4 As a result of the BT Global Services operational review, (described on page 11) the group has recorded restructuring charges of £280m, with further costs of around £420m expected to be recorded over the next two years, the majority of which will be in 2010. These charges are expected to result in a net cash outflow of approximately £260m in 2010 and £50m in 2011. The main components of the specific item are set out below.

Networks and products rationalisation as a result of the rationalisation of the legacy networks, including the associated systems and processes, a charge of £183m has been recognised, representing the difference between the recoverable amount and the carrying value of the assets impacted by the rationalisation. In addition, further dual running and transition costs of approximately £70m are expected to be incurred over the next two financial years as the rationalisation programme is completed.

People and property a charge of £51m has been recognised, relating to the costs associated with the people and property aspects of the restructuring and rationalisation. The main components of the charge are leaver costs and property exit costs. Further people leaver related costs of approximately £350m are expected to be incurred over the next two financial years.

Intangible asset impairment a charge of £46m has been recognised, reflecting the costs associated with rationalising the services that are offered to customers and the brands under which customers are served. The charge includes the write down of brands and other acquired intangible assets that no longer have an economic value to the business.

4 A charge of £65m (2008: £402m, 2007: £nil) was recognised in respect of restructuring costs relating to the group s transformation and reorganisation activities. The costs mainly comprise leaver costs, property exit and transformation programme costs.

4 A charge of £50m was recognised, comprising £31m of asset impairments and £19m of associated costs, following the group s review of its 21CN programme and associated voice strategy in the light of the move to a customer-led roll out strategy and focus on next generation voice service developments of fibre based products.

4 A credit of £36m was recognised in respect of a reassessment of the value of our share of the net assets of an associated undertaking.

4 A tax credit of £43m (2008: £149m, 2007: £41m) arose on specific items.

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The specific items set out below did not impact 2009, but were recognised in the comparative years.

4 A £64m charge in 2007 incurred in respect of property rationalisation costs.

4 Charges of £53m in 2008 and £30m in 2007, were recognised in relation to further estimated costs required to create Openreach and deliver the Undertakings agreed with Ofcom, particularly with regard to the introduction of equivalence of input systems.

4 Charges of £74m in 2008 and £65m in 2007 were recognised as a result of the completion of a review of circuit inventory and other working capital balances.

4 Profit on the sale of associates of £9m in 2008 and £22m in 2007. In 2008, the £9m profit arose from the receipt of contingent consideration from the disposal of the group s interest in e-peopleserve. In 2007, the £22m profit arose from the disposal of 6% of the group s equity interest in the associate Tech Mahindra Limited.

4 In 2008, the group agreed an outstanding tax matter relating to a business disposed of in 2001, the impact of which was a tax credit of £40m, and this closed all open items in relation to the settlement reached in 2007. In 2007, the group agreed the settlement of substantially all open UK tax matters relating to ten tax years up to and including 2004/05 with HM Revenue and Customs (HMRC). In 2007, the total impact of the settlement was a net credit of £1,067m, comprising a tax credit of £938m representing those elements of the tax charges previously recognised which were in excess of the final agreed liability, interest income of £139m and operating costs of £10m, representing the costs associated with reaching this agreement. A tax credit of £154m was also recognised in 2008 for the re-measurement of deferred tax balances as a result of the change in the UK statutory corporation tax rate from 30% to 28%, effective in 2009.

Net finance expense

	2009 £m	2008 £m	2007 £m
Interest on borrowings	935	822	728
Loss arising on derivatives not in a designated hedge relationship	29	41	4
Interest on pension scheme liabilities	2,308	2,028	1,872
Total finance expense	**3,272**	**2,891**	**2,604**
Income from listed investments			(7)
Other interest and similar income	(31)	(65)	(72)
Expected return on pension scheme assets	(2,621)	(2,448)	(2,292)
Total finance income	**(2,652)**	**(2,513)**	**(2,371)**
Analysed as:			
Net finance expense before specific items and pensions	933	798	653
Interest associated with pensions	(313)	(420)	(420)
Net finance expense before specific items	620	378	233
Specific items			(139)

Net finance expense	**620**	**378**	**94**

In 2009, net finance expense before specific items was £620m (2008: £378m, 2007: £233m). The net finance income associated with the group s defined benefit pension obligation of £313m was £107m lower than in 2008, which in turn was at the same level as in 2007. The interest on pension scheme liabilities and expected return on pension scheme assets reflects the IAS 19 assumptions and valuation as at the start of the financial year. This is expected to be a net interest cost of about £275m in 2010 as a result of the significant reduction in asset values during 2009.

Interest on borrowings was £935m in 2009 (2008: £822m, 2007: £728m). The increase of £113m in 2009 reflects higher net debt mainly due to lower free cash flow being exceeded by dividend and share buy back payments. The increase in 2008 of £94m reflects higher net debt and higher interest rates on variable rate borrowings. Losses arising on derivatives not in a designated hedge relationship was £29m in 2009 (2008: £41m, 2007: £4m). In 2008, losses on derivatives not in a designated hedge relationship of £41m included a charge of £26m on a low cost borrowing transaction which was marginally earnings positive after tax in the year.

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6.5p
full year proposed dividend

Interest income arising from listed investments and other interest and similar income was £31m in 2009 compared with £65m in 2008 reflecting lower levels of investments held by the group and lower average interest rates on deposits. In 2008, the reduction in interest income of £14m reflects the lower level of investment holdings following their utilisation to fund bond maturities.

Adjusted operating profit represented 2.6 times net finance expense before specific items and the net finance income associated with the group s defined benefit pension obligation, which compares with interest cover of 3.6 times in 2008 and 4.2 times in 2007. The reduction in cover was largely due to lower operating profits in the year and higher borrowing costs. Interest cover of reported operating profit represented 0.7 times net finance expense in 2009 (2008: 6.2 times, 2007: 27.0 times).

Associates and joint ventures

The results of associates and joint ventures before specific items are shown below:

	2009 £m	2008 £m	2007 £m
Share of post tax profit (loss) of associates and joint ventures	39	(11)	15

Our share of the post tax profit (loss) from associates and joint ventures was a profit of £39m in 2009 (2008: £11m loss, 2007: £15m profit). Our most significant associate is Tech Mahindra Limited, which contributed £33m of post tax profit in 2009 (2008: £11m loss, 2007: £21m profit). The profits in 2009 reflect a focus on efficiency and costs. The loss in 2008 reflects Tech Mahindra s investment in the expansion of its global capabilities during the year.

Profit before taxation

Adjusted profit before taxation was £1,877m in 2009, compared with £2,506m in 2008 and £2,495m in 2007. The reduction in 2009 is primarily due to the unacceptable performance in BT Global Services, partially offset by good performance in the other lines of business. In 2008, adjusted profit before taxation was broadly flat year on year, with the increase in operating profit being largely offset by the increase in net finance expense.

Reported loss before taxation was £134m in 2009, compared with profit before taxation of £1,976m in 2008 and £2,484m in 2007.

Taxation

The tax credit for 2009 was £53m and comprised a tax credit of £10m on the profit before taxation and specific items and a credit of £43m on specific items. The effective rate of the tax credit on the profit before taxation and specific items was (4.2)%, reflecting the tax credit arising on the contract and financial review charges of £1.6bn (see page 10) recorded in the year.

The net tax charge in 2008 was £238m and comprised a charge of £581m on profit before taxation and specific items, offset by a tax credit of £343m on certain specific items. The net tax credit in 2007 was £368m and comprised a charge of £611m on profit before taxation and specific items, offset by a tax credit of £41m on certain specific items and a further specific tax credit of £938m arising on settlement of substantially all open UK tax matters relating to ten tax years up to and including the 2004/05 year.

Earnings per share

Adjusted basic earnings per share were 18.4p in 2009, compared with 23.9p in 2008 and 22.7p in 2007, reflecting the reduced profitability. In 2009, the reported basic loss per share was 1.1p (2008: earnings per share 21.5p, 2007: earnings per share 34.4p). The table below reconciles adjusted to reported earnings per share.

2009	2008	2007

	pence	pence	pence
Adjusted basic earnings per share[a]	18.4	23.9	22.7
Contract and financial review charges and specific items	(19.5)	(2.4)	11.7
Reported basic (loss) earnings per share	(1.1)	21.5	34.4

[a] Adjusted amounts refer to the amounts before contract and financial review charges recorded within BT Global Services and specific items.

Reported diluted (loss) earnings per share were not materially different from reported basic (loss) earnings per share in any year under review.

Dividends

The Board recommends a final dividend of 1.1p per share (2008: 10.4p per share, 2007: 10.0p per share) to shareholders, amounting to approximately £85m (2008: £805m, 2007: £825m). This will be paid, subject to shareholder approval, on 7 September 2009 to shareholders on the register on 14 August 2009. When combined with the 2009 interim dividend of 5.4p per share, the total dividend proposed for 2009 is 6.5p per share, totalling £503m (2008: £1,236m, 2007: £1,247m). This compares with 15.8 pence in 2008 and 15.1 pence in 2007, a decrease of 59% following the increase in 2008 of 5%.

Dividends paid in 2009 were £1,222m (2008: £1,241m, 2007: £1,053m) and have been presented as a deduction to shareholders equity.

Financing

In 2009, cash generated from operations was £4,934m (2008: £5,187m, 2007: £5,245m), a reduction of 5% compared with 2008. In 2008, cash generated from operations included pension deficiency payments of £320m.

In 2009, the group paid net tax of £228m, compared with a net tax refund of £299m received in 2008. The net refund received in 2008 included a receipt of £521m in relation to the settlement of open tax years up to and including 2004/05, together with tax paid of £222m. In 2007, the group paid net tax of £35m, which included the initial cash receipt of £376m in relation to the settlement with HMRC. In 2009, net cash inflow from operating activities was £4,706m (2008: £5,486m, 2007: £5,210m).

BUSINESS AND FINANCIAL REVIEWS FINANCIAL REVIEW

Cash flow
Summarised cash flow statement

	2009 £m	2008 £m	2007 £m
Cash generated from operations	4,934	5,187	5,245
Net income taxes (paid) repaid	(228)	299	(35)
Net cash inflow from operating activities	**4,706**	**5,486**	**5,210**
Net purchase of property, plant, equipment and software	(3,038)	(3,253)	(3,209)
Net acquisition of subsidiaries, associates, joint ventures and group undertakings	(227)	(364)	(237)
Net sale (purchase) of current and non current financial assets	286	(160)	515
Dividends received from associates and joint ventures	6	2	6
Interest received	19	111	147
Net cash used in investing activities	**(2,954)**	**(3,664)**	**(2,778)**
Net drawdown (repayment) of borrowings	522	2,061	(765)
Equity dividends paid	(1,222)	(1,236)	(1,057)
Net repurchase of shares	(209)	(1,413)	(279)
Interest paid	(956)	(842)	(797)
Net cash used in financing activities	**(1,865)**	**(1,430)**	**(2,898)**
Effect of exchange rates on cash and cash equivalents	54	25	(35)
Net (decrease) increase in cash and cash equivalents	**(59)**	**417**	**(501)**
Increase in net debt resulting from cash flows	(921)	(1,510)	(219)

Net cash outflow from investing activities was £2,954m in 2009 (2008: £3,664m, 2007: £2,778m). In 2009, net cash outflow for the purchase of property, plant and equipment was £3,038m (2008: £3,253m, 2007: £3,209m). The decrease in 2009 reflects the lower capital expenditure across the group. The increase in 2008 reflects preparations for 21CN and the systems developments required by the Undertakings agreed with Ofcom. Net cash expenditure on acquiring new businesses was £227m in 2009 (2008: £364m, 2007: £237m). Significant acquisitions made in the current year include Wire One Holdings Inc (£74m), Ribbit Corporation (£46m) and Ufindus Ltd (£21m). In 2008, significant acquisitions included Comsat International, Frontline Technologies Corporation Limited and i2i Enterprise Private Limited. In 2007, significant acquisitions included INS Inc and PlusNet.

In 2009, the net cash inflow from the net sale of investments was £286m, compared with an outflow of £160m in 2008, and an inflow of £515m in 2007. The cash flows in all financial years mainly related to changes in amounts held in liquidity funds.

Interest received was £19m in 2009, compared with £111m in 2008 and £147m in 2007. The interest receipts in 2008 and 2007 include £65m and £74m, respectively, from HMRC on the settlement discussed in the specific items section of this Financial review. Excluding these receipts, interest received was £27m lower in 2009 reflecting lower levels of investments held by the group and lower average interest rates on deposits. In 2008, interest received was £27m lower reflecting the lower level of investment holdings following their utilisation to fund bond maturities, the share buy back programme and liquidity management.

Net cash outflow from financing activities of £1,865m in 2009 compares with £1,430m in 2008 and £2,898m in 2007. In 2009, the group raised debt of £795m mainly through our European Medium Term Note programme and received £606m from the net issue of commercial paper. This was partially offset by cash outflows on the repayment of maturing borrowings and lease liabilities amounting to £879m. In 2008, the group raised debt of £3,939m mainly through its European Medium Term Note and US Shelf programmes which was partially offset by cash outflows on the repayment of maturing borrowings, lease liabilities and the net repayment of commercial paper amounting to £1,878m. In 2007, the full and part maturity of notes and leases resulted in a cash outflow of £1,085m mainly offset by the net issue of commercial paper of £309m.

At 31 March 2009, net debt was £10,361m, compared with £9,460m at 31 March 2008 and £7,914m at 31 March 2007. The components of net debt, which is a non-GAAP measure, together with a reconciliation to the most directly comparable IFRS measure, are detailed on page 103. The share buy back programme has resulted in a cash outflow of £334m compared with £1,498m in 2008 and £400m in 2007.

Equity dividends paid in 2009 were £1,222m, compared with £1,236m and £1,057m in 2008 and 2007, respectively. Interest paid in 2009 was £956m, compared with £842m and £797m in 2008 and 2007, respectively. Interest payments in 2008 included a one-off payment of £26m on the close out of derivatives associated with a low cost borrowing transaction. Excluding this payment, interest paid was £140m higher in 2009, which in turn was £19m higher in 2008, reflecting the impact of increased average net debt.

During 2009, the share buy back programme continued until July 2008 and we repurchased 143m shares for cash consideration of £334m. During 2008 and 2007 we repurchased 540m and 148m shares for cash consideration of £1,498m and £400m, respectively. We also issued 83m shares out of treasury to satisfy obligations under employee share scheme exercises receiving consideration of £125m (2008: £85m, 2007: £123m).

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Free cash flow

	2009 £m	2008 £m	2007 £m
Net cash inflow from operating activities	4,706	5,486	5,210
Net purchase of property, plant equipment and software	(3,038)	(3,253)	(3,209)
Net purchase of non current financial assets		(1)	(3)
Dividends from associates and joint ventures	6	2	6
Interest received	19	111	147
Interest paid	(956)	(842)	(797)
Free cash flow	737	1,503	1,354

The components of free cash flow, which is a non-GAAP measure and a key performance indicator, are presented in the table above and reconciled to net cash inflow from operating activities, the most directly comparable IFRS measure. For further discussion of the definition of free cash flow, refer to pages 47 and 48.

The decrease in free cash flow in 2009 of £766m is largely due to lower EBITDA, higher net income tax paid in the year and higher net interest payments, partially offset by lower cash payments in respect of capital expenditure.

The increase in free cash flow in 2008 of £149m is largely due to the income tax repayment from HMRC of £521m (2007: £376m), a reduction in income taxes paid of £189m, lower pension deficiency payments of £320m (2007: £520m), together with an improvement in working capital movements. These improvements were partially offset by payments of £297m associated with our transformation activities and higher cash payments in respect of capital expenditure and net interest paid.

Balance sheet

Summarised balance sheet

	2009 £m	2008 £m
Non current assets		
Intangible assets	3,788	3,355
Property, plant and equipment	15,405	15,307
Retirement benefit asset		2,887
Trade and other receivables	322	854
Other non current assets	3,746	426
	23,261	22,829
Current assets		
Trade and other receivables	4,185	4,449
Cash and cash equivalents	1,300	1,435
Other current assets	528	639
	6,013	6,523

Current liabilities		
Loans and other borrowings	1,542	1,524
Trade and other payables	7,215	7,591
Other current liabilities	595	589
	9,352	9,704
Total assets less current liabilities	19,922	19,648
Non current liabilities		
Loans and other borrowings	12,365	9,818
Deferred tax liabilities	1,728	2,513
Retirement benefit obligations	3,973	108
Other non current liabilities	1,687	1,777
	19,753	14,216
Equity		
Ordinary shares and share premium	470	482
Retained (loss) earnings	(328)	4,927
	142	5,409
Minority interest	27	23
Total equity	169	5,432
	19,922	**19,648**

Net assets at 31 March 2009 were £169m compared with £5,432m at 31 March 2008, with the reduction of £5,263m mainly due to the loss for the year of £81m, actuarial losses of £7,037m, dividend payments of £1,222m, partly offset by the tax credit relating to items recorded directly in equity of £1,847m, gains on cash flow hedges of £570m and foreign exchange movements on the translation of overseas operations of £692m.

BT s non current assets totalled £23,261m at 31 March 2009, of which £15,405m were property, plant and equipment, principally forming the UK fixed network. At 31 March 2008, non current assets were £22,829m and property, plant and equipment were £15,307m.

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We believe it is appropriate to show the sub-total Total assets less current liabilities of £19,922m at 31 March 2009 (2008: £19,648m) in the group balance sheet because it provides useful financial information being an indication of the level of capital employed at the balance sheet date, namely total equity and non current liabilities.

BT Group plc, the parent company, whose financial statements are prepared in accordance with UK GAAP, had profit and loss reserves (net of the treasury reserve) of £9,761m at 31 March 2009, compared with £10,513m at 31 March 2008.

Capital expenditure

Capital expenditure is a measure of our expenditure on property, plant and equipment and software. It excludes the movement on capital accruals and any assets acquired through new acquisitions in a year. Capital expenditure totalled £3,088m in 2009 compared with £3,339m and £3,247m in 2008 and 2007, respectively. The reduction in expenditure in 2009 reflects a reduction in expenditure on exchange equipment and reduced provisioning volumes in Openreach due to a lower level of house moves and reduced LLU volumes from other CPs. This has been partly offset by increased expenditure on 21CN. The increased expenditure in 2008 related to investment in the creation of re-useable capabilities for major contracts and up front capital expenditure associated with contract wins at the end of the year. 21CN expenditure was higher than 2007 and included equipment deployment, customer site readiness as well as customer migration. 21CN expenditure is mainly reflected in other network equipment. The additional expenditure on 21CN has been partially offset by reduced spend on legacy equipment, including transmission and exchange equipment. Capital expenditure is expected to reduce to around £2.7bn in 2010.

Of the capital expenditure, £316m arose outside of the UK in 2009, unchanged from the £316m in 2008. Contracts placed for ongoing capital expenditure totalled £451m at 31 March 2009.

Acquisitions

The total consideration for acquisitions in 2009, was £186m. Goodwill arising on acquisitions made in 2009 was £131m.

The acquisition of Stemmer GmbH and SND GmbH was completed by BT Global Services in July 2008 for a total consideration of £13m. Net of cash acquired, the net cash outflow was £12m. The provisional fair value of net assets at the date of acquisition was £3m, giving rise to goodwill of £10m. No other acquisitions were made by BT Global Services in the year.

BT Retail made two acquisitions in the year, Wire One Holdings Inc and Ufindus Ltd, for total consideration of £98m. Net of cash acquired, the net cash outflow in respect of these acquisitions was £95m. The fair value of net assets acquired was £24m, giving rise to goodwill of £74m.

BT Design made two acquisitions in the year, Ribbit Corporation and Moorhouse Consulting Ltd, for total consideration of £75m. Net of deferred consideration and cash acquired, the net cash outflow in respect of these acquisitions was £60m. The provisional fair value of the combined net assets at the date of acquisition was £28m, giving rise to goodwill of £47m.

The total consideration for acquisitions in 2008 was £477m. The acquisition of Comsat completed in June 2007 for a total consideration of £130m. Net of deferred consideration and cash acquired, the net cash outflow was £122m. The fair value of Comsat s net assets at the date of acquisition was £57m, giving rise to goodwill of £73m. Other acquisitions made by BT Global Services in 2008, for a total consideration of £276m, include Frontline, Technologies Corporation Limited, i2i Enterprise Private Limited and Net 2S SA (a company which changed its name to BT Services SA on 1 April 2009). Net of deferred consideration and cash acquired, the net cash outflow in respect of these acquisitions was £187m. The fair value of the companies net assets at the various dates of acquisition was £82m, resulting in goodwill of £194m.

Acquisitions made by BT Retail in 2008, for a total consideration of £71m, include Lynx Technology, Basilica and Brightview. Net of deferred consideration and cash acquired, the net cash outflow was £60m. The provisional fair value of the companies net assets at the various dates of acquisition was £24m, giving rise to goodwill of £47m.

Return on capital employed

The adjusted return on the average capital employed was 15.1% for 2009. In 2008 and 2007 we made an adjusted return of 17.7% and 17.6%, respectively. On a reported basis, the return on the average capital employed was 2.9% for 2009 (2008: 14.4%, 2007: 16.5%).

Pensions

Detailed pensions disclosures are provided in note 29 to the consolidated financial statements. At 31 March 2009, the IAS 19 accounting deficit was £2.9bn, net of tax, compared with a surplus of £2.0bn at 31 March 2008. The deterioration in asset values from £37.4bn at 31 March 2008 to £29.3bn at 31 March 2009 principally reflects the decline in global financial markets during the year. During the year the investment management de-risking activities have continued and this has further reduced the proportion of funds invested in equities from 45% to 31%.

During the year we conducted a review of our UK pension arrangements, including extensive consultation with the trade unions and employees. The aim of the review was to ensure the schemes remain flexible, fair and sustainable for the long-term. Changes to the future benefit accruals under the BTPS were effective from 1 April 2009 and benefits built up before this date are protected and remain linked to final pensionable salary. The changes include increasing the normal retirement age to 65, changing to a career average revalued earnings basis, changes to member contributions and ceasing to contract out of the State Second Pension. We expect these changes will reduce regular cash contributions, net of increased National Insurance Contributions, by about £100m per annum.

The number of retired members and other current beneficiaries in the BTPS has been increasing in recent years. Consequently, our future pension costs and contributions will depend on the

BUSINESS AND FINANCIAL REVIEWS FINANCIAL REVIEW

investment returns of the pension fund and life expectancy of members and could fluctuate in the medium-term.

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 which provides benefits based on the employees and the employing company s contributions.

BT and the Trustee of the BTPS have agreed that deficit contributions of £525m per annum will be made in cash or in specie over the next three years. This agreement has been approved by the Pensions Regulator.

BT and the Trustee have also reached an advanced stage in the completion of the triennial funding valuation, being prepared by the scheme s independent actuary, as at 31 December 2008. As the parties are at an advanced stage compared to other scheme valuations and given the uncertain market conditions, the Pensions Regulator has indicated it wishes to discuss with the Trustee and BT the underlying assumptions and basis of the valuation. The Pensions Regulator has requested that the valuation and assumptions are not finalised or disclosed in advance of the completion of those discussions. BT, the Trustee and the Pensions Regulator are keen to complete this as soon as practicable.

The previous valuation was carried out as at 31 December 2005 which showed the fund was in deficit by £3.4bn. The deficit payments of £280m per annum agreed in respect of the previous valuation have now been replaced by the agreement to pay £525m per annum over the next three years.

The group is paying a regular contribution rate of 19.5% of pensionable pay, of which 6% to 7% is payable by employees.

Capital management

The primary objective of the group s capital management policy is to target a solid investment grade credit rating whilst continuing to invest for the future and, with an efficient balance sheet, further enhance the return to shareholders. In order to meet this objective, the group may issue new shares, repurchase shares, adjust the amount of dividends paid to shareholders, or issue or repay debt. 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 these objectives, policies and processes during 2009 and 2008.

The group s capital structure consists of net debt, committed facilities and similar arrangements and shareholders equity (excluding the cash flow reserve). The following analysis summarises the components which are managed as capital:

	2009 £m	2008 £m
Total parent shareholders (deficit) equity (excluding cash flow reserve)	(421)	5,252
Net debt (see note 10)	10,361	9,460
Undrawn committed facilities (see note 33)	2,300	2,335
	12,240	**17,047**

The Board reviews the group s dividend policy and funding requirements at least annually. The Board is committed to delivering attractive returns for shareholders and believes that the operational improvements in the business will generate sufficient cash flow to allow the dividend to grow at the same time as investing in the business, reducing debt and supporting the pension scheme.

During 2008, the group commenced a £2.5bn share buy back programme, which was expected to be completed by 31 March 2009. However, in July 2008, the Board suspended this programme as a result of the group s strategic investment in fibre deployment. During 2009, 143m shares for cash consideration of £334m were repurchased. During

2008 and 2007, 540m and 148m shares were repurchased for cash consideration of £1,498m and £400m, respectively.

The general policy is to raise and invest funds centrally to meet anticipated requirements using a combination of capital market bond issuance, commercial paper borrowing backed up by committed borrowing facilities and investments. These financial instruments vary in their maturity in order to meet short, medium and long-term requirements. In June 2008, £795m of long-term funds were raised and in March 2009 the group renewed £800m of its 364 day facility with a one-year term out. A further £100m was agreed after the balance sheet date.

At 31 March 2009 the group had financial assets of £7.3bn consisting of current and non current investments, derivative financial assets, trade and other receivables, cash and cash equivalents. Credit exposures are continually reviewed and proactive steps have been taken to ensure that the impact of the current adverse market conditions on these financial assets is minimised. In particular, line of business management have been actively reviewing exposures arising from trading balances and, in managing investments and derivative financial instruments, the centralised treasury operation has continued to monitor the credit quality across treasury counterparties and is actively managing exposures which arise.

At 31 March 2009, the group s credit rating was BBB with stable outlook with Standard and Poor s and Baa2 with negative outlook with Moody s (2008: BBB+/Baa1, both with stable outlook). After the balance sheet date, Fitch changed the group s credit rating to BBB with a stable outlook (2008: BBB+ with a stable outlook).

Capital resources

The Business review and Other Matters sections on pages 8 to 31 includes information on the group structure, the performance of each of the lines of business, the impact of regulation and competition, principal risks and uncertainties and the group s outlook. This Financial review section on pages 32 to 48 includes information on our financial position, cash flows, liquidity position, borrowing position and the group s objectives, policies and processes for capital management. Notes 9, 10, 13, 16, 17 and 33 of the Consolidated Financial Statements include information on the group s investments, derivatives, cash and cash equivalents, borrowings, financial risk management objectives, hedging policies

BUSINESS AND FINANCIAL REVIEWS FINANCIAL REVIEW

and exposures to credit, liquidity and market risks.

During the period under review the group s net debt increased to £10.4bn at 31 March 2009 compared with £9.5bn at 31 March 2008 and £7.9bn at 31 March 2007 (based on the definition of net debt as set out in note 10).

The following table sets out the group s contractual obligations and commitments as they fall due for payment, as at 31 March 2009.

		Payments due by period			
Contractual obligations and commitments	Total £m	Less than 1 year £m	Between 1 and 3 years £m	Between 3 and 5 years £m	More than 5 years £m
Loans and other borrowings[a]	13,573	1,528	3,066	1,819	7,160
Finance lease obligations	332	14	42	24	252
Operating lease obligations	8,004	484	885	780	5,855
Pension deficiency obligations	2,695	525	1,050	560	560
Capital commitments	451	380	62	6	3
Total	**25,055**	**2,931**	**5,105**	**3,189**	**13,830**

[a] Excludes fair value adjustments for hedged risks.

At 31 March 2009, the group had cash, cash equivalents and current asset investments of £1,463m. The group also had unused committed borrowing facilities, amounting to £2,300m. At 31 March 2009, £1,190m of debt principal (at hedged rates) fell due for repayment in the 2010 financial year. These resources will allow the group to settle its obligations as they fall due. The group has no significant debt maturities until December 2010.

The directors have a reasonable expectation that the group has adequate resources to continue in operational existence for the foreseeable future and therefore continue to adopt the going concern basis in preparing the financial statements. There has been no significant change in the financial or trading position of the group since 31 March 2009.

Off-balance sheet arrangements

As disclosed in the 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 the following:

Operating leases (note 27)

Capital commitments and guarantees (note 27)

Taxation

Total tax contribution

BT is a significant contributor to the UK Exchequer, collecting and paying taxes of over £3bn in a typical year. In 2009 we collected and paid £1,239m of VAT, £1,178m of PAYE and National Insurance, £210m of UK corporation tax and £236m of UK business and UK network rates.

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 BT Board regularly reviews the group s tax strategy.

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 is entirely proper that the group conducts an appropriate level of responsible tax planning in managing its tax affairs, being consistent with its obligations to protect the assets of the company for the benefit of our shareholders. This planning is carried out within Board defined parameters.

We operate in over 170 countries and with this comes additional complexity in the taxation arena. However 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 and including 2005 are fully agreed. For 2006 and 2007, there are a number of open issues which we are actively discussing with HMRC with a view to resolving. The UK corporation tax returns for 2008 were all filed prior to the statutory deadline of 31 March 2009.

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.

Our positive working relationship with HMRC was demonstrated in 2007 when we worked intensively with HMRC to accelerate the agreement of all open tax matters up to and including 2005. This project allowed us to build and develop our working relationship with HMRC.

We have a policy to lobby the government directly on tax matters that are likely to impact us and in particular respond to consultation documents where the impact could be substantial. We also lobby the government indirectly through the CBI, various working groups and committees and leading professional advisors.

Tax accounting

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 a high degree of judgement.

In 2007 and 2008, the cash tax paid is lower than the income statement charges. This is partly due to the phasing of UK corporation tax instalments, the level of provisioning for risks, taxation of specific items, the impact of deferred tax and the impact of overseas losses or profits which are relieved or taxed at different tax rates from the UK. In 2009, we have paid cash tax in excess of our income statement charge. We expect to obtain a refund of the cash tax paid in relation to the 2009 liability in the near future.

It is expected that the cash tax paid will increase in the medium term, despite the introduction of enhanced capital allowances in the current financial year.

The effective corporation tax rate on profits before specific items is expected to increase from (4.2)%, the rate applicable to 2009. The 2009 rate reflects the tax credit arising on the BT Global Services contract and financial review charges of £1.6bn (see page 10) recorded in the year. However, we believe that the future years tax effective rate will remain below the statutory rate of 28%.

Financial risk management

The group issues or holds financial instruments mainly to finance its operations; to finance corporate transactions such as dividends, share buy backs and acquisitions; for the temporary investment of short-term funds; and to manage the currency and interest rate risks arising from its operations and from sources of finance. In addition, various financial instruments, for example trade receivables and trade payables, arise directly from the group s operations.

The group has a centralised treasury operation whose primary role is to manage liquidity, funding, investments and counterparty credit risk arising with financial institutions. The centralised treasury operation also manages the group s market risk exposures, including risks arising from volatility in currency and interest rates. The centralised treasury operation is not a profit centre and the objective is to manage risk at optimum cost.

The Board sets the policy for the group s centralised treasury operation and its activities are subject to a set of controls commensurate with the magnitude of the borrowings and investments and group wide exposures under its management. The Board has delegated its authority to operate these policies to a series of panels that are responsible for the management of key treasury risks and operations. Appointment to and removal from the key panels requires approval from two of the Chairman, the Chief Executive or the Group Finance Director.

The financial risk management of exposures arising from trading related financial instruments, primarily trade receivables and trade payables, is through a series of policies and procedures set at a group and line of business level. Line of business management apply these policies and procedures and perform review processes to assess and manage financial risk exposures arising from these financial instruments.

Foreign exchange risk management

A significant proportion of the group s current revenue is invoiced in Sterling, and a significant element of its operations and costs arise within the UK. The group s overseas operations generally trade and are funded in their functional currency which limits their exposure to foreign exchange volatility. The group s foreign currency borrowings, which totalled £9.9bn at 31 March 2009, are used to finance its operations and have been predominantly swapped into Sterling using cross currency swaps. The group also enters into forward currency contracts to hedge foreign currency investments, interest expense, capital purchases and purchase and sale commitments on a selective basis. The commitments hedged are principally US dollar and Euro denominated. As a result, the group s exposure to foreign currency arises mainly on its non UK subsidiary investments and on residual currency trading flows.

After hedging, with all other factors remaining constant and based on the composition of assets and liabilities at the balance sheet date, the group s exposure to foreign exchange volatility in the income statement from a 10% strengthening in Sterling against other currencies would result in a credit of approximately £20m in 2009.

Interest rate risk management

The group has interest bearing financial assets and financial liabilities which may expose the group to either cash flow or fair value volatility. The group s policy, as prescribed by the Board, is to ensure that at least 70% of net debt is at fixed rates.

The majority of the group s long-term borrowings have been, and are, subject to Sterling fixed interest rates after applying the impact of hedging instruments. The group has entered into interest rate swap agreements with commercial banks and other institutions to vary the amounts and period for which interest rates are fixed.

The long-term debt instruments which the group issued in December 2000 and February 2001 both contained covenants providing that if the BT Group credit rating were downgraded below A3 in the case of Moody s or below A minus in the case of Standard & Poor s (S&P), additional interest would accrue from the next interest coupon period at the rate of 0.25 percentage points for each ratings category adjustment by each ratings agency. In March 2009, both Moody s and S&P downgraded BT s credit rating to Baa2 and BBB, respectively. Prior to this financial year, S&P downgraded BT s credit rating to BBB+ in July 2006 and Moody s downgraded BT s credit rating to Baa1 in May 2001. Based on the debt of £5.8bn outstanding on these instruments at 31 March 2009, BT s annual finance expense would increase by approximately £28m if BT s credit rating were to be downgraded by one credit rating category by both agencies below a long-term debt rating of Baa2/BBB. If BT s credit rating with each of Moody s and S&P were to be upgraded by one credit rating category, the annual finance expense would be reduced by approximately £28m.

After the impact of hedging, the group s main exposure to interest rate volatility in the income statement arises from fair value movements on derivatives not in hedging relationships and on variable rate borrowings and investments which are largely influenced by Sterling interest rates. Trade payables, trade receivables and other financial instruments do not present a material exposure to interest rate volatility. With all other factors remaining constant and based on the composition of net debt at 31 March 2009, a 100 basis point increase in Sterling interest rates would decrease the group s annual net finance expense by approximately £5m.

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Credit risk management

The group s exposure to credit risk arises from financial assets transacted by the centralised treasury operation (primarily derivatives, investments, cash and cash equivalents) and from its trading related receivables. For treasury related balances, the Board defined policy restricts exposure to any one counterparty by setting credit limits based on the credit quality as defined by Moody s and Standard and Poor s and by defining the types of financial instruments which may be transacted. The minimum credit ratings permitted with counterparties are A3/A for long-term and P1/A1 for short-term. The centralised treasury operation continuously reviews the limits applied to counterparties and will adjust the limit according to the nature and credit standing of the counterparty up to the maximum allowable limit set by the Board. Management review significant utilisations on a regular basis to determine the adjustments required, if any, and actively manage any exposures which may arise. Where multiple transactions are undertaken with a single counterparty, or group of related counterparties, the group may enter into netting arrangements to reduce the group s exposure to credit risk. Currently, the group makes use of standard International Swaps and Derivative Association (ISDA) documentation. In addition, where possible, the group will seek a combination of a legal right of set off and net settlement. The group also seeks collateral or other security where it is considered necessary. During the 2009 financial year, the centralised treasury operation tightened the credit limits applied when investing with counterparties in response to market conditions, continued to monitor their credit quality and actively managed any exposures which arose.

Note 17 discloses the credit concentration and credit quality of derivative financial assets. After applying a legal right of set off under the group s ISDA documentation, the group had a net exposure to derivative counterparties of £2,282m. Of this, 85% was with six counterparties. The majority of these derivatives are in designated cash flow hedges. With all other factors remaining constant and based on the composition of net derivative financial assets at 31 March 2009, a 100 basis point increase in yield curves across each of the ratings categories within which these derivative financial assets are classified would reduce their carrying values and impact equity, pre-tax, as follows:

	Impact of 100 basis point increase £m
Moody s/S&P credit rating	
Aa2/AA	(18)
Aa3/AA	(21)
A1/A+	(92)
A2/A	(146)
A3/A	
	(277)

The group s credit policy for trading related financial assets is applied and managed by each of the lines of business to ensure compliance. The policy requires that the creditworthiness and financial strength of customers is assessed at inception and on an ongoing basis. Payment terms are set in accordance with industry standards. The group will also enhance credit protection when appropriate, taking into consideration the customer s exposure to the group, by applying processes which include netting and offsetting, and requesting securities such as deposits, guarantees and letters of credit. The group has taken proactive steps to minimise the impact of adverse market conditions on trading related financial assets. The concentration of credit risk for trading balances of the group is provided in note 15 which analyses outstanding balances by line of business and reflects the nature of customers in each segment.

Liquidity risk management

The group ensures its liquidity is maintained by entering into short, medium and long-term financial instruments to support operational and other funding requirements. On at least an annual basis the Board reviews and approves the maximum long-term funding of the group and on an ongoing basis considers any related matters. Short and medium-term requirements are regularly reviewed and managed by the centralised treasury operation within the parameters set by the Board. The primary objective of the group s capital management policy is to target a solid investment grade credit rating whilst continuing to invest for the future and, with an efficient balance sheet, further enhance the return to shareholders.

The group s liquidity and funding management process includes projecting cash flows and considering the level of liquid assets in relation thereto, monitoring balance sheet liquidity and maintaining a diverse range of funding sources and back-up facilities. The Board reviews group forecasts, including cash flow forecasts, on a quarterly basis. The centralised treasury operation reviews cash flows more frequently to assess the short and medium-term requirements. These assessments ensure the group responds to possible future cash constraints in a timely manner. Liquid assets surplus to immediate operating requirements of the group are generally invested and managed by the centralised treasury operation. Operating finance requirements of group companies are met whenever possible from central resources.

The group has a European Medium Term Note programme and a US Shelf registration in place of which 3.9bn and $6.9bn, respectively, have been utilised. During the 2009 and 2008 financial years the group issued commercial paper and held cash, cash equivalents and current asset investments in order to manage short-term liquidity requirements. At 31 March 2009, the group had an undrawn committed borrowing facility of up to £1,500m. The facility is available for the period to January 2013. The group had an additional undrawn committed borrowing facility of £900m, of which £800m was agreed in the 2009 financial year (2008: £835m), with a further £100m agreed after the balance sheet date. This facility is for a term of 364 days from March 2009 with a one-year term out.

BUSINESS AND FINANCIAL REVIEWS FINANCIAL REVIEW

Refinancing risk is managed by limiting the amount of borrowing that matures within any specific period and having appropriate strategies in place to manage refinancing needs as they arise. The group has no significant debt maturities until December 2010.

Price risk management

The group has limited exposure to price risk.

Further information on financial instruments is disclosed in notes 5, 9, 10, 15, 16, 17 and 33 to the Consolidated financial statements.

Critical accounting policies

Our principal accounting policies are set out on pages 79 to 87 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 2009 financial statements.

We, in common with virtually all other companies, need to use estimates in the preparation of our financial statements. The most sensitive estimates affecting our financial statements are in the areas of assessing the level of interconnect income with and payments to other telecommunications operators; providing for doubtful debts; establishing asset lives of property, plant and equipment for depreciation purposes; assessing the stage of completion and likely outcome under long-term contracts; making appropriate long-term assumptions in calculating pension liabilities and costs; making appropriate medium-term assumptions on asset impairment reviews; calculating current and deferred tax liabilities; and determining the fair values of certain financial instruments. Details of critical accounting estimates and key judgements are provided in the accounting policies on page 85.

Alternative performance measures

We assess the performance of the group using a variety of measures, some of which are not explicitly defined under IFRS, and are therefore termed non-GAAP measures . These measures are in addition to, and supplement, those prepared in accordance with IFRS. The alternative performance measures we use include earnings before interest, tax, depreciation and amortisation (EBITDA); adjusted EBITDA; adjusted operating profit; underlying revenue; underlying operating costs; adjusted profit before taxation; adjusted earnings per share; free cash flow; and net debt. Free cash flow and adjusted basic earnings per share are also the group s key financial performance indicators.

Why we use each of these alternative performance measures is explained below. Reconciliations to the nearest measure prepared in accordance with IFRS are included within the body of the Financial review and in the financial statements. The alternative performance measures we use may not be directly comparable to similarly titled measures used by other companies.

EBITDA

In addition to measuring financial performance of the lines of business based on operating profit, we also measure performance based on EBITDA. EBITDA is defined as the group profit or loss before depreciation, amortisation, finance expense and taxation. Since this is a non-GAAP measure, it may not be directly comparable to the EBITDA of other companies, as they may define it differently. 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 to be a useful measure of our operating performance because it reflects the underlying operating cash costs, by eliminating depreciation and amortisation. EBITDA is not a direct measure of our liquidity, which is shown by our cash flow statement, and it needs to be considered in the context of our financial commitments.

Results before specific items

In our income statement and segmental analysis we separately identify specific items and present our results both before and after these items. This is consistent with the way that financial performance is measured by management 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 significant one-off or unusual in nature and have little predictive value. Items that we consider to be significant one-off or unusual in nature include disposals of businesses and investments, business restructuring costs, asset impairment charges and property rationalisation programmes. An analysis of specific items recorded in all years presented is included on pages 37 and 38.

Underlying revenue and operating costs

Underlying revenue and operating costs refers to the amounts excluding 1) the contribution in the current year from acquisitions that are not reflected in the comparable period in the prior year due to the date the acquisition was completed, and 2) the impact of rebasing the current year to be on a constant currency basis compared with the prior year. No adjustment is made to the prior year reported revenue or operating costs in determining the year on year movement in underlying revenue and operating costs. The directors believe that presentation of the group s revenue and operating costs in this way is relevant to an understanding of the group s financial performance. Both acquisitions and foreign exchange rate movements can have significant impacts on the group s reported revenue and operating costs and therefore can impact year on year comparisons. Presentation of the group s revenue and operating costs excluding the year on year impact of acquisitions and on a constant currency basis allows the group s revenue and operating costs to be presented on a consistent basis for the purpose of year on year comparisons. A reconciliation of underlying revenue to reported revenue is included on page 33. A reconciliation of underlying operating costs to reported operating costs is given on page 35.

Adjusted performance measures

Performance measures presented as adjusted are stated before contract and financial review charges recorded within BT Global Services and specific items. As explained on page 10, during 2009, the new management team undertook an extensive review of BT Global Services financial position and contracts. Having completed the contract and financial reviews, a charge of £1,639m was recognised in 2009 (2008 and 2007: £nil). Given the size of these charges, we have presented EBITDA, operating profit, profit before taxation and earnings per share before these charges and specific items as the directors believe that the presentation of the group s results in this way is relevant to an understanding of the group s financial performance. A reconciliation from adjusted EBITDA to operating profit, the most directly comparable IFRS measure is included on pages 34 and 35. A reconciliation from adjusted profit before taxation to the reported (loss) profit is included on page 32. A reconciliation from adjusted earnings per share to reported (loss) earnings per share is included on page 39.

Free cash flow

Free cash flow is one of our key performance indicators with which our performance against our strategy is measured. Free cash flow is defined as the net increase in cash and cash equivalents less cash flows from financing activities (except interest paid) and less the acquisition or disposal of group undertakings and less the net sale of short-term investments. 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, 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 free cash flow does not mean that this is a measure of the funds that are available for distribution to shareholders. A reconciliation of free cash flow to net cash inflow from operating activities, the most directly comparable IFRS measure, is included on page 41.

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 as required by IAS 39. In addition, the gross balances are adjusted to take account of netting arrangements.

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 of net debt to this measure is included on page 103. It is considered both useful and necessary to disclose net debt as it is a key measure against which performance against the group s strategy is measured. It 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.

REPORT OF THE DIRECTORS

We are committed to operating in accordance with best practice in business integrity, maintaining the highest standards of financial reporting, corporate governance and ethics. The directors consider that BT has, throughout the year, complied with the provisions set out in Section 1 of the 2006 Combined Code on Corporate Governance (the Code) and has applied the principles of the Code as described in this report.

REPORT OF THE DIRECTORS
BOARD OF DIRECTORS AND OPERATING COMMITTEE

Board of Directors

Sir Michael was appointed to the Board as Chairman on 26 September 2007. He chairs the *Nominating Committee* and the *Committee for Responsible and Sustainable Business* and is a member of the *Remuneration Committee* and 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 the UK Commission for Employment and Skills, and a non-executive director of Barclays, McGraw Hill and the Financial Reporting Council. Sir Michael s appointments include vice-president of the RNIB, member of the board of the TransAtlantic Business Dialogue, member of the CBI International Advisory Board, the Chartered Management Institute and BERR s US/UK Regulatory Taskforce.

A Chartered Accountant, he was knighted in 2007 for his services to the accountancy profession. Aged 61.

Executive directors

Ian Livingston was appointed as Chief Executive on 1 June 2008. He was formerly Chief Executive of BT Retail from 7 February 2005 and Group Finance Director from April 2002. Prior to 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. He is a Chartered Accountant. Aged 44.

Tony Chanmugam was appointed to the Board on 1 December 2008 as Group Finance Director. 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 at BT Global Solutions. He is a Chartered Management Accountant. Aged 55.

Hanif Lalani was appointed Chief Executive, BT Global Services, on 1 November 2008. He was Group Finance Director from 7 February 2005. He was formerly Chief Financial Officer for BT Wholesale. Since joining BT in 1983, he has held a number of positions, including Chief Executive of BT Northern Ireland and Managing Director BT Regions. Hanif was also chairman of OCEAN Communications (BT s subsidiary in the Republic of Ireland). He was awarded the OBE in 2003 for services to business in Northern Ireland. He is a Chartered Management Accountant. Aged 47.

Gavin Patterson was appointed to the Board on 1 June 2008. He joined BT in January 2004 as Managing Director, Consumer Division, BT Retail and was appointed Chief Executive, BT Retail on 1 May 2008. Before joining BT, he was managing director of the consumer division of Telewest. Gavin joined Telewest in 1999 and held a number of commercial and marketing roles, after working for Procter & Gamble since 1990. Aged 41.

Non-executive directors

Maarten van den Bergh was appointed to the Board on 1 September 2000. He was appointed Deputy Chairman on 1 October 2006. He chairs the *Remuneration Committee* and the *Pension Scheme Performance Review Group*. He is the senior independent director. He will step down from the Board at the conclusion of the 2009 AGM.

Prior to his retirement in July 2000, Maarten was president of the Royal Dutch Petroleum Company and vice-chairman of its committee of managing directors from July 1998, having been appointed a managing director of the Royal Dutch Shell Group of companies in July 1992.

He is a non-executive director of British Airways. A Dutch national, he is aged 67.

Matti Alahuhta was appointed to the Board on 1 February 2006 and will be stepping down on 31 May 2009. He has been president of Kone Corporation since 2005, president and CEO since 2006 and a director since 2003. He was formerly at Nokia Corporation for more than 20 years, where his most recent roles were executive vice-president and chief strategy officer, president mobile phones and president telecommunications.

Matti is a member of the Executive Committee of the International Institute for Management Development (IMD), a non-executive director of UPM-Kymmene Corporation, and chairman of the board of trustees of Aalto University, Helsinki. A Finnish national, he is aged 56.

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REPORT OF THE DIRECTORS BOARD OF DIRECTORS AND OPERATING COMMITTEE

Clay Brendish was appointed to the Board on 1 September 2002.

Prior to his retirement in May 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.

He is non-executive chairman of Anite, Close Beacon Investment Fund and Echo Research and a non-executive director of Herald Investment Trust. He is also a trustee of Economist Newspapers. Aged 62.

Eric Daniels was appointed to the Board on 1 April 2008. He has been group chief executive of Lloyds Banking Group (formerly Lloyds TSB Group) since 2003 and a director since 2001, and was formerly group executive director, UK retail banking. He worked for Citibank from 1975 to 2000 becoming chief operating officer of Citibank s consumer bank, then chairman and CEO of Travelers Life and Annuity following its merger with Citibank. After that, Eric was chairman and chief executive of Zona Financiera from 2000 to 2001 before joining Lloyds TSB Group. A US National, he is aged 57.

Patricia Hewitt was appointed to the Board on 24 March 2008. Labour MP for Leicester West, she was Secretary of State for Health from 2005 to 2007 and previously for 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. Patricia is a senior adviser to Cinven and a special consultant to Alliance Boots. A British and Australian dual national, she is aged 60.

Phil Hodkinson was appointed to the Board on 1 February 2006. He chairs the *Audit Committee*. A Fellow of the Institute of Actuaries, prior to his retirement in 2007, Phil s former roles included group finance director of HBOS, chairman of Insight Investment and Clerical Medical, and chief executive of Zurich Life and Eagle Star Life.

Phil is a non-executive director of HM Revenue & Customs, Travelex, Resolution, Christian Aid and Business in the Community. Aged 51.

Deborah Lathen was appointed to the Board on 1 February 2007. She is a US attorney and has been president of Lathen Consulting (which provides strategic, legal and management advice on policy and regulatory matters to senior executives of major US companies) since 2001. From 1998 to 2001 she worked at the Federal Communications Commission (FCC) as chief of the Cable Services Bureau where she was responsible for policy and regulation covering the cable, satellite TV and broadcast industries.

Prior to joining the FCC, Deborah held roles as director of national consumer affairs and managing counsel at Nissan Motor Corporation USA and legal positions at TRW Financial Systems and the Quaker Oats Company. A US national, she is aged 56.

Carl Symon was appointed to the Board on 14 January 2002, and was appointed chairman of the *Equality of Access Board* when it became operational on 1 November 2005. 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 63.

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 49.

Operating Committee

Ian Livingston, Chief Executive
Tony Chanmugam, Group Finance Director
Hanif Lalani, Chief Executive, BT Global Services
Gavin Patterson, Chief Executive, BT Retail
Sally Davis, Chief Executive, BT Wholesale
Roel Louwhoff, Chief Executive, BT Operate

Al-Noor Ramji, Chief Executive, BT Design

Key to membership of Board committees:
[a]Operating
[b]Audit
[c]Remuneration
[d]Nominating
[e]Responsible and Sustainable Business
[f]Pension Scheme Performance Review Group
[g]Equality of Access Board

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REPORT OF THE DIRECTORS
THE BOARD
Introduction

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 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 2009 financial year.

The **Business review, Other matters and Financial review** sections on pages 8 to 48 form part of this report. The audited financial statements are presented on pages 79 to 135 and 141.

We are committed to operating in accordance with best practice in business integrity, maintaining the highest standards of financial reporting, corporate governance and ethics. The directors consider that BT has, throughout the year, complied with the provisions set out in Section 1 of the 2006 Combined Code on Corporate Governance (the Code) and applied the principles of the Code as described in this Report.

Directors

The names and biographical details of the directors are given on pages 50 to 51 in **Board of Directors and Operating Committee**.

Changes to the composition of the Board from 1 April 2008 are set out in the table below:

Former directors	Date of change
Ben Verwaayen	30 June 2008
François Barrault	30 October 2008
New directors	
Tony Chanmugam	1 December 2008
Eric Daniels	1 April 2008
Gavin Patterson	1 June 2008

Ian Livingston, formerly Chief Executive, BT Retail, succeeded Ben Verwaayen as Chief Executive, BT Group on 1 June 2008. Gavin Patterson replaced Ian Livingston as Chief Executive, BT Retail, on 1 May 2008. François Barrault resigned as Chief Executive, BT Global Services and as a director on 30 October 2008. He was succeeded by Hanif Lalani, formerly Group Finance Director. Tony Chanmugam joined the Board and succeeded Hanif Lalani as Group Finance Director on 1 December 2008. Maarten van den Bergh who is Deputy Chairman and the senior independent director will step down from the Board at the conclusion of the 2009 AGM. His successor will be announced in due course. Matti Alahuhta is stepping down as a non-executive director on 31 May 2009.

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, three other executive directors and eight non-executive directors. All the non-executive directors during the 2009 financial year met, and continue to meet, the criteria for independence set out in the Combined Code and are therefore considered by the Board to be independent. The Board viewed the Chairman as independent at the time of his appointment. In line with BT s policy, the Board comprised a majority of independent non-executive directors throughout the 2009 financial year.

The Board s main focus is overall strategic direction, development and control. It approves BT s:

4 values;

4 business practice policies;

4 strategic plans;

4 annual budget;

4 capital expenditure and investments budgets; larger capital expenditure proposals; and

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

The Board also oversees 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 12 times during the 2009 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 Committee*. As well as chairing the Board, the Chairman consults the non-executive directors, particularly the Deputy Chairman, on corporate governance issues, matters considered by the *Nominating Committee*, which the Chairman chairs, and the individual performance of the 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** above. 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; for instance, the Board approved the change of Company Secretary from 1 April 2008.

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REPORT OF THE DIRECTORS THE BOARD

BT s non-executive directors

The *Nominating 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 the Committee, which then recommends to the Board candidates for appointment.

The non-executive directors provide a strong, independent element on the Board. 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.

In his capacity as Deputy Chairman, and as the chairman of the *Remuneration Committee*, Maarten van den Bergh is available to meet from time to time with BT s major institutional shareholders. He is able 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. At the end of the first three years the appointment may be continued by mutual agreement. 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 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 investments budgets, monitors financial, operational and customer quality of service performance, reviews the risk register, 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 delegate these approvals, up to its own limits, to senior executives.

To meet best corporate governance practice, the *Audit Committee*, the *Remuneration Committee* and the *Nominating 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 Committee**, the **Report of the Nominating Committee** and the **Report on directors remuneration** are on pages 54 to 69. This year, for the first time, a **Report of the Committee for Responsible and Sustainable Business** is included on page 56. The *Equality of Access Board* (EAB) was established on 1 November 2005, 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. The EAB is a committee of the Board, which formally approved the formation of the EAB and its terms of reference. 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, Himanshu Raja, Chief Financial Officer, BT Design; 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 Board also has a *Pension Scheme Performance Review Group*.

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. We have a *Nominating Committee* chaired by the Chairman, Sir Michael Rake, but this does not develop corporate governance principles for the Board s approval. The Board itself approves the group s overall system of internal controls, governance and compliance authorities. The Board and the *Nominating Committee* are made up of a majority of independent, non-executive directors.

The Sarbanes-Oxley Act of 2002, the US Securities and Exchange Commission (SEC) and NYSE introduced rules on 31 July 2005 requiring us to comply with certain provisions relating to the *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.

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REPORT OF THE DIRECTORS
REPORT OF THE AUDIT COMMITTEE

Introduction

The *Audit Committee* is chaired by Phil Hodkinson. The other members are Maarten van den Bergh, Clay Brendish, Patricia Hewitt and Carl Symon. They are all independent non-executive directors. With the exception of Patricia Hewitt who joined the Committee on 8 May 2008, they were members of the Committee throughout the 2009 financial year. Appointments are for a period of up to three years, which may be extended for two further three year periods, provided the director remains independent. The Board considers that the Committee s members generally have broad commercial knowledge and extensive business leadership experience, having held between them various prior roles in major business, Government and financial management, treasury and financial function supervision and that this constitutes a broad and suitable mix of business, financial management and IT experience. The Board has reviewed membership of the Committee and is satisfied that it includes a member in the person of Phil Hodkinson who has the recent and relevant financial experience required for the provisions of the Code and is an audit committee financial expert for the purposes of the US Sarbanes-Oxley Act. The Committee typically meets four times each financial year: in May, July, November and February and the chairman of the Committee reports 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 Committee*, will attend meetings with the agreement of the chairman of the Committee. The external auditors will normally attend meetings, although they will not be present when the Committee discusses their performance and/or remuneration.

The papers and minutes of *Audit Committee* meetings are 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. It ensures that key partners are rotated at appropriate intervals. The partner currently responsible for BT s audit has held that position for two years. 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. During the 2009 financial year, the Committee placed particular emphasis on understanding the quality of audits conducted in respect of the group s overseas subsidiaries and is satisfied that the performance of the external audit process continues to be effective. 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 work. 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 will not be offered to the external auditors unless there are clear efficiencies and value-added benefits to the company. The overall policies and the 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 Committee* monitors the extent of non-audit work being performed by the external auditors and approves any work not included on the list of services the Committee has pre-approved before it is undertaken. It also monitors the level of non-audit fees paid to the auditors. Details of non-audit work carried out by the external auditors are in note 32 in the **Notes to the consolidated financial statements** on page 129.

The *Audit 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 disclosure 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 material 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 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.

It 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.

It 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 and independent investigation and appropriate follow up action.

Committee activities

At each of its meetings, the Committee reviews with the Director Internal Audit and appropriate executives the implementation and effectiveness of key operational and functional change and remedial programmes and IT programmes. The Committee also sets aside time at every meeting to seek the views of the internal and external auditors in the absence of management.

During the year, the *Audit Committee* business included consideration of the following:

May:

4 the effectiveness of internal control procedures;

4 the annual financial statements, full year results announcement, and related formal statements;

4 the basis of accounting for long term contracts;

4 BT Global Services major contracts review;

4 annual review of security, business continuity and fraud;

4 annual report on the performance of the Internal Audit and Regulatory Compliance functions;

4 annual update on whistleblowing .

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REPORT OF THE DIRECTORS **REPORT OF THE AUDIT COMMITTEE**

July:

4 non-audit services governance policy;

4 Audit Committee and External Audit effectiveness;

4 first quarter results, announcement and related formal statements;

4 BT Global Services major contracts review;

4 pension accounting assumptions;

4 management of corporate fraud risks.

October:

4 review and approval of trading update.

November:

4 review of fees for audit and non-audit work;

4 half year results, announcement and related formal statements;

4 BT Global Services major contracts review;

4 review of global assurance capabilities;

4 half year report on the performance of Internal Audit and Regulatory Compliance;

4 review of internal control requirements under Sarbanes-Oxley and the Combined Code for the 2009 financial year;

4 review of regulatory developments;

4 external audit plan.

January:

4 review and approval of trading update.

February:

4 third quarter results, announcement and related formal statements;

4 BT Global Services major contracts review;

4 trends on auditing and accounting issues in overseas operations;

4 annual review of accounting policies;

4 the process for post investment reviews;

4 review of the operation of Sarbanes-Oxley S404 processes;

4 the Internal Audit Plan for the 2010 financial year.

The Committee evaluated its performance and processes by again inviting Committee members and key executives and the external auditors to complete questionnaires. This formed part of the annual Board and Committee evaluation. Committee members, and those others consulted, continue to regard the Committee as effective on both behaviours and processes. The Committee agreed that there should be continued focus on the conciseness and improving the clarity of papers and that the Board annual accounting seminar should cover enterprise-wide risk management processes in addition to key financial issues. The Committee also reviewed the experience, skills and succession planning within the Group Finance function.

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REPORT OF THE DIRECTORS
REPORT OF THE NOMINATING COMMITTEE

Introduction

The *Nominating Committee* is chaired by the Chairman. The other members are the Deputy Chairman, Clay Brendish, Eric Daniels and Phil Hodkinson. Clay Brendish and Eric Daniels joined the Committee on 8 May 2008. Four of its five 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 and activities

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 Committee* ensures an appropriate balance of experience and abilities on the Board, using this evaluation to review the size and composition of the Board and recommending any proposed changes to the Board.

It 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 Deputy Chairman 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, Chief Executive and all other Board appointments.

The Committee met twice during the 2009 financial year. It reviewed Board succession, the size, profile and composition of the Board, and the Board and Committee evaluation questionnaire and process. Under the leadership of the Chairman, the Committee, supported by the Committee s appointed search consultants, MWM, conducted a thorough search process to identify candidates for the positions of Chief Executive, and consequently of Chief Executive BT Retail, Chief Executive BT Global Services and consequently Group Finance Director. The Committee recommended to the Board the internal appointments of Ian Livingston (formerly Chief Executive BT Retail), Gavin Patterson, Hanif Lalani (formerly Group Finance Director) and Tony Chanmugam respectively.

The Committee also reviewed and recommended to the Board, following rigorous review, the continued appointment of Clay Brendish and Phil Hodkinson for a further three years. Clay Brendish and Phil Hodkinson retire by rotation at the 2009 AGM.

The minutes of *Nominating Committee* meetings are sent, at their request, to directors who are not members of the Committee, where appropriate to do so.

Board evaluation

The *Nominating Committee* considered options for an independent third party conducting the sixth formal evaluation in 2008, and, following Board discussion, this was subsequently carried out by Egon Zehnder during February-April 2008 by way both of questionnaire and interview. The review focused on unlocking greater effectiveness rather than grading the past. Private sessions were held with each director and feedback was given to them individually.

The Board considered the results of the review and agreed a number of recommendations. Progress has been made in implementing them; in particular, the membership of the *Nominating Committee* has been increased, the *Remuneration Committee* has simplified the structure of executive remuneration, customer segment strategies have continued to be discussed and more time has been set aside in Board meetings for the discussion of customer service and the right first time initiative. A further review was carried out by the Chairman and Secretary through a questionnaire and discussion with directors in April 2009. The results of the work are currently being considered and reviewed by the Board and an action plan will be produced. The Deputy Chairman reviewed the performance of the Chairman taking into account the views of the non-executive directors.

Separate questionnaires about *Audit Committee* effectiveness were also completed and the outcome of the review are in the **Report of the Audit Committee**.

Report of the Committee for Responsible and Sustainable Business

Introduction

The *Committee for Responsible and Sustainable 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 Hodkinson and Deborah Lathen and three independent members: Lord Hastings, Baroness Jay and Dame Ellen MacArthur.

Committee role

With input and recommendations from executive management and advice from an independent experts panel, the Committee sets the responsible and sustainable business strategy for the BT group globally (including wholly owned subsidiaries) for approval by the Board, and reviews and agrees implementation plans and targets, evaluates performance, embeds responsible activity into standard business practice, 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 optimise the positive impact of BT as an organisation through exemplary application of communication services; and through responsible policies, behaviour and practices. It promotes world class corporate responsibility (CR) performance to minimise any CR risks to BT s operations and reputation, and helps to maximise business opportunities from CR. It encourages the innovation of new communication services that help create a more sustainable society and ensures that BT both adopts best practice and policy in the workplace, including the development of skills and talent, and makes a fitting contribution to the communities within which BT operates. It met three times in the 2009 financial year.

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REPORT OF THE DIRECTORS
REPORT ON DIRECTORS REMUNERATION

The Report on directors remuneration is divided into the following sections:

4 Remuneration policy (not audited)

(i) Role of the Remuneration Committee

(ii) Remuneration principles

(iii) Remuneration in 2008/09 and 2009/10

(iv) Other matters

Executive share ownership

Pensions

Other benefits

Directors who have left the Board

Service agreements

Outside appointments

Non-executive directors letters of appointment

Non-executive directors remuneration

Directors service agreements and contracts of appointment

Directors interests

Performance graph

4 Remuneration review (audited)

Directors emoluments

Former directors

Loans

Pensions

Share options

Share awards under long-term incentive plans

Vesting of outstanding share awards and options

Deferred Bonus Plan awards

Share awards under the Employee Share Investment Plan and Allshare International

Remuneration policy

This part of the Report on directors remuneration is not subject to audit.

Shareholders will be asked to vote on this Report at the 2009 AGM.

(i) Role of the Remuneration Committee

The *Remuneration Committee*, under delegated authority from the Board, 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 changes to the executive share plans and recommends to the Board any changes 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 reward-related matters and confirms that the company has complied with all aspects. The Chairman, Sir Michael Rake, is a member of the Committee, in accordance with the provision of the Combined Code permitting a company chairman to be a member of, but not chair, the remuneration committee.

The terms of reference of the Committee are available on the company s website at **www.bt.com/committees**. The Committee met five times during 2008/09. In addition to the Chairman, the members of the Committee are non-executive directors. The Deputy Chairman, Maarten van den Bergh, has been chairman of the Committee since October 2006 and the other members who served during 2008/09 were:

4 Sir Michael Rake

4 Matti Alahuhta

4 Eric Daniels (appointed 8 May 2008)

4 Deborah Lathen

4 Carl Symon

In addition, the Chief Executive is invited to attend meetings, except when it would be inappropriate for him to be there, for example, when his 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.

The Committee has received advice during the year from independent remuneration consultants, Kepler Associates, who were appointed by the company. Kepler advises both the Committee and the company and attends Committee meetings when major remuneration issues are discussed. They provide no other services to the company. The Committee also regularly consults the Chief Executive, the Group Finance Director, the Group HR Director, the Director Reward and Employee Relations, and the Company Secretary.

(ii) Remuneration principles

BT s policy is to reward its senior executives competitively, taking account of the performance of the individual lines of business and the company as a whole, remuneration of other FTSE 30 companies and the competitive pressures in the global information and communications technology (ICT) industry. This ICT comparison is important as an increasing proportion of BT s revenues is derived from networked IT services and broadband.

The Committee has amended the policy such that base salaries are typically positioned at levels below the median of the comparator group, with the remuneration package as a whole (basic salary, annual bonus in cash and deferred shares and the expected value of any long-term incentives) having the potential to deliver upper quartile rewards only for sustained and excellent performance.

A significant proportion of the total remuneration package bonuses and long-term incentives is variable and is linked to corporate performance. The performance targets are reviewed regularly to ensure that they are challenging.

In setting remuneration of the directors, the Committee takes into account the pay and employment conditions of employees elsewhere in the group.

The Committee is satisfied that the incentive structure for senior executives does not raise environmental, social and governance risks by inadvertently motivating irresponsible behaviour. As members of the Board, all Committee members receive and review an annual corporate responsibility report detailing the way in which the company manages social, ethical and environmental issues. The *Committee for Responsible and Sustainable Business*, chaired by Sir Michael Rake, meets three or four times each year.

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REPORT OF THE DIRECTORS REPORT ON DIRECTORS REMUNERATION

(iii) Remuneration in 2008/09 and 2009/10
The structure of the remuneration is set out below:

	2008/09	2009/10 changes agreed by shareholders	2009/10 Actual
Base salary	increases to align with the market	increases to align with the market	no increases
Annual bonus			
Chief Executive	target 100% salary maximum 200% salary	target 125% salary maximum 200% salary	no increases applied no change to
Executive directors	target 80% salary maximum 120% salary	target 100% salary maximum 150% salary	2008/09 levels
Deferred bonus (in shares)			
Chief Executive	1x cash bonus	1x cash bonus	no change
Executive directors	75% of cash bonus	75% of cash bonus	no change
Incentive shares			
Chief Executive	3x salary	3x salary	no change
Executive directors	2.5x salary	2.5x salary	no change
Retention shares	none	no change	none
Share options	none	no change	none

Note: Under his contract, the Chairman is not entitled to a bonus or an annual grant of share awards or options.

Remuneration in 2008/09

Salaries

Salaries are reviewed annually but increases are made only where the Committee believes the adjustments are appropriate to reflect the contribution of the individual, increased responsibilities and market conditions. In June 2008, the salary of Ian Livingston was increased reflecting his appointment as Chief Executive. Hanif Lalani s salary was increased at the same time to bring his overall package more into line with the market.

Annual bonus

The annual bonus is linked to corporate performance targets set at the beginning of the financial year. In 2008/09, 30% of the scorecard related to earnings per share (EPS), 30% related to free cash flow, 30% related to customer service and 10% related to each director s contribution to the company s environmental, social and governance objectives (ESG).

The outcome measured against corporate targets in 2008/09 is set out below:

Earnings per share	Free cash flow	Customer service
0%	0%	24.4%

Note: target is 100% and stretch is 200%

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 income relating to the group s pension liabilities were excluded from the target.

All executive directors and members of the *Operating Committee* will, immediately after payment, use their annual cash bonus for 2008/09, net after tax, to purchase shares in the company.

The deferred element of the annual bonus is paid in shares under the Deferred Bonus Plan (DBP). The shares vest and are transferred to the executive after three years if they remain employed by the company. There are currently no additional performance measures for the vesting of deferred share awards. The Committee considers that deferring a part of the annual bonus in this way also acts as a retention measure and contributes to the alignment of management with the long-term interests of the shareholders. The deferred awards for previous years for Ian Livingston, Tony Chanmugam, Hanif Lalani and Gavin Patterson at the end of the financial year 2008/09 are contained in the table on page 68.

Remuneration in 2009/10

In 2007/08, the *Remuneration Committee* reviewed the senior executive remuneration package. At that time, as BT had enjoyed a period of relative success and had delivered good performance for its shareholders, the Committee decided to implement a new remuneration structure to be phased in during 2008/09 and 2009/10. This structure was designed to bring the remuneration of executive directors into line with that of the FTSE 30 and of ICT companies. The revised structure also eliminated the need to put in place overlay arrangements in the form of additional grants of deferred and retention shares, which had been made in previous years in order to retain key executives. These changes were approved by shareholders.

In the light of the current difficult market and trading conditions, however, executive directors indicated that they did not wish to receive the second stage increases that had been approved in 2007/08. The Committee decided to postpone the increases in on-target bonus levels for 2009/10. In addition, there will be no increases in the salaries of executive directors in 2009/10. There will be no changes to the level of awards of incentive shares granted and no retention share awards or options will be granted.

Details of the package are set out in the table above.

Annual bonus

For annual bonuses, the structure of the corporate scorecard will be adjusted in 2009/10. 15% of the weighting will relate to each individual s contribution to the company s environmental, social and governance (ESG) objectives. The EPS and cash flow elements will each remain at 30% and the customer service measure will be 25% of the weighting.

As in the previous two financial years, for purposes of calculating EPS for the scorecard, volatile items reported under IFRS will be excluded from the target.

The Committee believes that the group performance targets for the financial year 2009/10 are very challenging.

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REPORT OF THE DIRECTORS REPORT ON DIRECTORS REMUNERATION

Proportion of fixed and variable remuneration
The composition of each executive director s performance-related remuneration, excluding pension, is as follows:

	Fixed base pay	Variable	Total
Ian Livingston			
2009/10 target composition[a]	24%	76%	100%
2008/09 actual composition[b]	58%	42%	100%
Tony Chanmugam			
2009/10 target composition[a]	29%	71%	100%
2008/09 actual composition[b]	65%	35%	100%
Hanif Lalani			
2009/10 target composition[a]	29%	71%	100%
2008/09 actual composition[b]	76%	24%	100%
Gavin Patterson			
2009/10 target composition[a]	29%	71%	100%
2008/09 actual composition[b]	62%	38%	100%

[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, excluding retention shares.

[b] Actual remuneration comprises base salary, actual cash bonus and the value received from deferred shares and incentive shares (awards granted in 2005 and vested in 2008) during the financial year.

Long-term incentives

The BT Equity Incentive Portfolio comprises three elements: share options, incentive shares and retention shares. Awards may be granted under the Global Share Option Plan (GSOP), the Incentive Share Plan (ISP) and the Retention Share Plan (RSP). Incentive shares were used for equity participation in the financial year 2008/09. Retention shares are used by exception only, and principally as a recruitment or retention tool. Neither the Committee nor management deemed it appropriate to consider the rebasing of any share awards.

In April 2009, the Committee approved a change to the rules of each of the executive share plans providing for a clawback of unvested awards in circumstances where it becomes apparent that there was a misjudgment of the basis on which the award was made.

Performance measure

Normally, awards vest and options become exercisable only if a predetermined performance target has been achieved. The performance measure for outstanding awards and options is total shareholder return (TSR), calculated on a common currency basis and compared with a relevant basket of companies. TSR for these purposes was calculated by the law firm, Allen & Overy. TSR links the reward given to directors with the performance of BT against other major companies. TSR was measured against a group of companies from the European Telecom Sector. This comparator group was chosen because the companies faced similar market sector challenges to BT and are within the sector in which BT competes for capital.

At 1 April 2008, the group contained the following companies:

BT Group	Swisscom
Belgacom	Telecom Italia
Cegetel	Telecom Italia RNC
Deutsche Telekom	Telefonica
France Telecom	Telekom Austria

Hellenic Telecom	Telenor
Portugal Telecom	TeliaSonera
Royal KPN	Vodafone Group

All the above companies with the exception of Cegetel were members of the group as at 1 April 2007. Cosmote Mobile Telecommunications was also a member at that date. All the above companies, together with Telecom Mobiles and Telecom Italia Mobile but with the exception of Cegetel and Telecom Italia RNC, were members of the comparator group at 1 April 2006.

The TSR for a company is calculated by comparing the return index (RI) at the beginning of the performance period to 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, 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.

Changes to performance measure in 2009/10

The *Remuneration Committee* has reviewed the performance measure for the ISP. For awards granted in 2009 and in future years, it has determined that the TSR comparator group should be revised to better reflect the sectors in which BT now operates. The new comparator group will not be restricted to European telecoms companies and will contain companies which are either similar in size or market capitalisation and/or have a similar business mix and geographical spread to BT. The comparator group for the performance period commencing on 1 April 2009 contains the following companies:

Accenture	National Grid
AT & T	Portugal Telecom
Belgacom	Royal KPN
BSkyB	Swisscom
BT Group	Telecom Italia
Cable & Wireless	Telefonica
Cap Gemini	Telekom Austria
Carphone Warehouse	Telenor
Centrica	TeliaSonera
Deutsche Telecom	Verizon
France Telecom	Virgin Media
Hellenic Telecom	Vodafone
IBM	

In addition, 50% of each award will be linked to the TSR performance measure and 50% will be linked to a three-year cumulative free cash flow measure. This change was considered to be appropriate given the importance of cash generation to dividend payments.

REPORT OF THE DIRECTORS REPORT ON DIRECTORS REMUNERATION

This measure will be calibrated at a level considered by the Committee and confirmed by its independent adviser to be at a minimum as challenging as the previous measure.

For awards granted in 2009/10, performance will be assessed against a range of cumulative cash flow measures. 25% of the relevant part of the award will vest for performance at the lower end of the range, increasing on a straight line basis, such that 100% of the relevant part of the award will vest for performance at the upper end of the range.

A number of key investors and the main representative bodies were consulted about these changes and were supportive.

Incentive shares

For the financial year 2008/09, the Committee granted incentive shares to executive directors, senior executives, key managers and professionals.

Awards of incentive shares vest after a performance period of three years, if the participant is still employed by BT and a performance measure has been met. Dividends paid on the shares during the three-year period are reinvested in further shares and added to the awards. For awards of incentive shares granted in the financial years, 2006/07, 2007/08, 2008/09 and awards to be granted in 2009/10, TSR at the end of the three-year period must be in the upper quartile relative to the comparator group for all of the shares to vest. At median, 25% of the shares under the relevant part of the award will vest. Below that point, none of the shares under the relevant part of the award will vest. The proportion of shares that vests reduces on a straight-line basis between the upper quartile and median positions. There is no re-testing, and no matching shares are offered to any executive on vesting of the incentive shares.

At 31 March 2009, the TSR for the 2006/07 awards was at 14th position against the comparator group of companies. As a result none of the shares will vest and all of the share awards have lapsed.

The details of incentive share awards held by Ian Livingston, Tony Chanmugam, Hanif Lalani and Gavin Patterson at the end of the financial year 2008/09 are contained in the table on page 67.

Share options

No share options were granted under the GSOP in 2008/09. The last grant of such share options was in the financial year 2004/05.

The price at which shares may be acquired under the GSOP is the market price at the date of grant. Options are exercisable after three years, subject to a performance target TSR being met.

Since June 2007, 58% of the GSOP options granted in 2004/05 have been exercisable.

The details of the options held by Ian Livingston, Tony Chanmugam, Hanif Lalani and Gavin Patterson at the end of the financial year 2008/09 are contained in the table on page 66.

Retention shares

Retention shares are granted exceptionally under the RSP to individuals with critical skills, as a recruitment or retention tool. In some cases, they are granted to key employees who have contributed to excellent corporate performance to assist retention. As a result, shares currently under award are not generally linked 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 agreed 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.

Retention shares are used in special circumstances and, in the financial year 2008/09, two awards were granted for recruitment purposes. No awards of retention shares were granted to executive directors in 2008/09.

Other share plans

The executive directors and the Chairman may participate in BT s all-employee share plans, the Employee Sharesave Scheme, the International Employee Sharesave Scheme, Employee Share Investment Plan and Allshare International, on the same basis as other employees. There are further details of these plans in note 31 to the accounts.

Openreach

In the Undertakings given to Ofcom on 22 September 2005, BT agreed that the incentive elements of the remuneration of executives within Openreach should be linked to Openreach performance rather than BT targets or share price. These incentives cannot be provided by way of BT shares.

As a result, separate arrangements were put in place for Openreach executives in 2005/06. The annual bonus is linked solely to Openreach targets and long-term incentives are paid in cash instead of shares. However, payment of bonuses in Openreach is subject to overall affordability within BT Group.

Openreach executives participate in the BT all-employee share plans on the same terms as other BT employees.

None of the executive directors participates in the Openreach incentive plans.