BT Q2 results presentation

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Title of Meeting: **BT Q2 Results Presentation**

Hosted By: **Ian Livingston (IL)**

IL Good morning, welcome to BT for our Q2 results. I hope you like the little loop that we are running, that was of the BT Tower celebrating the start of the 1000 days to the Olympics and that is something we hope very much to be at the centre of and we were delighted with the coverage we got of that and actually now we have the top of the BT tower, one of the highest and largest…well actually it is the highest large sign in Europe, half a football pitch in length, so we can hopefully be transmitting great things from it.

As always forward looking statements, you will look at that at your leisure. I will go through the agenda today just to explain how we are going to split this. You will be delighted to know we have intentionally made this a shorter presentation than you are used to receiving at BT. What I will do is run through the results overall and also around the line of business, we are also looking at the Pension Fund and also I want to say something about Network investments, because we are continuing to invest in the future of the business and also we have given quite a lot of revised outlook at the half year, so we will talk through that.

Tony will take you through the income statement, talk through the details of the cash flow and also go through details of cost savings, so I won't really talk about that in any detail then I will come back on to just really give you a sense of where I think we are in BT's progress plan.

So first of all overall numbers. Revenue, headline revenue is down 3% underlying and that is excluding mergers and acquisitions and FX effect down 6%. As I will show later with Global Services, the true underlying is a little better than that there was a particular one off item this time last year, we will talk about that when it comes to Global Services. EBITDA, I am pleased to say was up 2% year on year. The first improvement for many, many quarters and that is really driven by the cost story, underlying costs down 575 million pounds and over 900 million for the year to date which is a decent element of the 1 billion, well over 1 billion original target we set and that is why we have given revised guidance.

In terms of earnings per share, down 8% on an underlying basis, so the key reason for that is what has happened on depreciation where we have brought a lot of assets into use. Again Tony will talk about that. Peak cash flow, very importantly, we have 705 million in the quarter, a big improvement on last year and year to date we have also achieved a big improvement, whilst some of that is due to tax it also reflects truly an underlying improvement in the business and hopefully is a pleasant number against what you have expected. Interim dividend, 2.3p for interim. The way we are going to look at the interim dividend, isn't as trying to [inaudible]do a the percentage of this year's dividend. But if you look at last year's dividend and try and…around about in this case 35% of last year but try to have that as something slightly over a third of last year's dividend and that is what we set it as this year.

Now turning to divisional performance. Global Services, I think I would call it continued progress, lots more to do, in terms of revenue, revenue as stated is 3% down, underlying revenue is shown down as 8%. Now let me talk about that as a sort of one off item. This time last year was a big milestone over 50 million pounds of revenue recognising a big contract milestone, that if you exclude that, actually the revenue for GS down to about 5% and that is probably a better underlying view of where it is. Where does that come from? Well particularly we have seen the effect of mobile termination rates affecting GS business, particularly its carrier business, but also in terms of equipment sales. Something we said for a couple of quarters, customers are buying less equipment so you see that in some of the equipment manufacturers. Other trends, pretty much as they have been and I will talk about where we are on contracts.

I am delighted to say underlying operating costs, down 8% and if you include CAPEX down 11%. That is a big improvement on the last quarter, which is a big improvement on the quarter before and that is what I mean about the trend; that give EBITDA improvements. Year on year EBITDA was still down because Q2 last year was over 100 million but actually if you start to look at sequential trends in GS we have gone 7, 32, 62, 95 consistent solid improvement, but as I stress we are only a few steps on the path that we need to do to make GS the business that it truly can become.

In terms of operational statistics for GS about three quarters ago we said we expected to see contract volumes being less than they had been, primarily because customers were taking longer to make decisions. That is quite normal in this sort of economic cycle. But also yes we are being tougher about what sort of business we want to do and the margins we have taken it, but I think the key primary reason is what is happening in the global economy. That being said, 1.4 billion of orders is pretty significant, both with new customers and we have gained some great new global customers, particularly in the FMCG sector, but also expanding with existing customers, such as Unilever, Anglo American is a new business and will be renewed. So good important customers, we are just trying to give you a sense of that.

Six months ago when we met and talked about the new operational structure, well we pretty much have got that in place now, it is still developing with a few tweaks to be done before the year end, but that structure was multinational corporations really done by sectorial basis, you would have FMCG, you had Finance, and really that would allow us far better to reuse the same sort of components to provide great, low cost, high quality solutions for our customers. Then we had the UK business, which should be UK Nationals rather than the UK Global companies. Then finally we have what we call GS Enterprises which is a bit like Retail Enterprises, stand alone businesses that really need the focus and to be judged on their own profitability and own performance. They have been set up and as we have looked at that and looked at a couple of performances and profitability we have made a couple of small disposals which basically were not strategic nor terribly interesting from a profitability point of view, so just a couple of small ones.

I think it is also important to say that during what has been a really tough time for GS and the news headlines haven't been good and we didn't deserve them to be good, GS customers have stayed with us partially because we give them good service. Already I talked a few months ago about Telemark. Telemark gave us the best customer service of any telco in the world with the best score they had ever given. Now that doesn't mean we can't improve because we can and we know we can. But also Ovum have…I was speaking to customers ranked as the global leader of global leaders, their quote not mine. But that gives a sense, we are…our customers are keeping faith with us, why? Because actually what we do for them is important and typically we like what we do. We just need to make sure from a financial point of view we deliver that same sort of global leaders for global leaders.

Now turn to Retail. Retail revenue down 5%. Basically the hardest hit part of that business has been the SME sector. Again given our previous common factor it shouldn't be as a shock. It has been squeezed more than other sectors, there is no question about it. Demand, bank borrowing, economy, etc, etc. We are doing pretty well on that sector it is just now it is really tough. It will come back over time but questionably it is tough and then you have got the normal trends you have seen, there is a line migration, people who just previously just provide the calls are taking over the lines or previously just did the broadband taking over the lines and that has affected us. Call volumes are down a bit, again not a huge shock.

So Retail is four year into a cost reduction programme. It achieved 9% cost reduction this quarter. That shows, cost reduction and becoming more efficient isn't a one year programme and I hope, and I get asked questions, before one of you asks the question when is the end of the efficiency programme? Answer, never. We have to continue to deliver better and better efficiency and drive it through improving process of customer service and be a better company. It is what good companies should always do.

What has happened in Retail is that again we have driven EBITDA performance, we are showing 11% EBITDA but again it will be very straightforward, there was some internal one off transfers which reverses out elsewhere in the Group and actually the underlying performance for Retail was about 7% up. That is very consistent with what we said to you, we said expect mid single digits for Retail for the rest this year and its very much running in line with that.

Some operational statistics. ARPU up 6 pounds to 296 pounds. For those of you with long memories, I think it has been 2005/06 ARPU was 250 pounds and there was this chart that showed ARPU coming down and down and down. We turned that around. We are selling more services to our customers, we are selling more broadband to them, there is a 43% market share for the quarter in Broadband, I will say it, I think it is now 6 quarters running I have made this statement in different positions in the company, that this number, because it is the quarterly number will tend to bounce around. The fact that it has been over 40% for ¾ running is unusual but we continue to do well. We continue to do better than the installed based market share which has been maintained at 35% and it is a tough market but we are doing very well in it.

Also BT Vision, we added underlying of 18,000 customers. The really interesting thing about Vision is its usage at the moment, over 90% of new customers of BT Vision today are taking on a package, with double digit pounds ARPU per month, you can take that over 10 pounds. The usage…the last quarter 33 million on demand views by BT Vision customers. That is three times what it was the same time last year and that is more than most terrestrial TV channels. So on demand and non linear is really becoming a real force. Your Vision households are using this a lot. It says something about the future of the way that interactivity may work.

Also we got a piece of restrictive regulation removed from us in the quarter - bundling. We can now really provide much better targeted bundling. So most of the customers at BT Consumer in particular lose consumer to people who offer bundles. We were fighting with two hands tied behind our back in terms of ability to target bundled offers to particular customers groups. That we can now do, so we have at least got one hand behind our back untied. I look forward to the day when we have both hands untied.

In terms of the SME sector, BTB, as I said there are the economic impacts having an effect. ICT Revenue down 4% against 8% for SME sector for overall business. Whenever we look at the market stats we are doing at least as well or better than the market in the overall SME market. But it is a tough market just now. One of the things we tried to do is react to that tough market by offering some really aggressive prices. So we launched a couple of weeks' ago a 15 pound a month package for unlimited calls. That would be a great deal wouldn't it? If it was just fixed line calls. But we can do better than that. It is £15 a month for all calls to fixed lines, all calls to 0845 and 0870 numbers, all calls to mobile numbers and that is a big change, all calls to mobile numbers included in the package and also all international calls bar in few countries. I did ask for a list of the countries and I have to inform you if you are really interested in calling the Solomon Isles and Vanuatau it is not for you! But pretty much every other country you would be interested in for £15 a month, the whole lot. Providing small businesses with real piece of mind and real value is what we need to do and I think that is the sort of final…we can mix it aggressively in the marketplace and we absolutely do so.

Now turning to Wholesale. I am delighted to say EBITDA in Wholesale up 1%. I think it has been two years plus since our CEO said Wholesale EBITDA was up. That is not because the overall market is improving, actually it still remains very tough, as we are seeing mobile termination of course come down, transit hasn't affected as much so far as I think it will do the second half and that is an assumption that transit could be a bit worse in the second half of this year, we have incorporated in our guidance for revenue. But what Wholesale has done a couple of things…first of all the operating costs are down and continue to be down, but also it is winning contracts to manage networks for other operators. About two, three years ago, about 10% of Wholesale's business was under contract. A year ago it was 20%, it is now 40%. It is winning business from people who have a choice. Frankly a number of years ago the only people who wanted the…no in fact the only people that did business with Wholesale was because they had no choice and they had to buy the services from them. Today what we are finding is customers such as KAKON, such as Vodafone, such as o2 and many, many others are choosing Wholesale to provide services, a wide range of services, well, well beyond regulatory services than you have a choice to go elsewhere. They are using Wholesale because actually…and one customer said to me, well actually your price is 5% more expensive than one of your key competitors, but we went with you because we trust you to deliver, we know you understand what being a good wholesaler is about and the quality of what you do. I used to buy from BT Wholesale many, many years ago, a different job, that is a big change. That is the most important thing that is happening in Wholesale and we hope that will continue.

Openreach. Openreach of course most utility like of all our businesses. Revenue down a bit, down 1%, that is the sort of fact you know about lower household formations, but also price reduction. The Ethernet price for instance were down by up to 60% and that is very important for the industry in terms of giving them a lower cost base generally. Many of the external CPs didn't actually mention that to the customers in the same way as they talked about local loop unbundling prices marginally increasing. But the prices are down there and that is affecting the revenue. But also what we are seeing is continued switch from internal provision to external CPs and that is the effect of local loop unbundling and the migration of lines that we saw on Retail.

Net Operating Costs, down 4%. A lot of that is coming from investment, investing in network. So for instance a few years ago, your line might go wrong once every 9 ½ years roughly. Six months' ago when I talked to you about it it was your line might go wrong once every 13 ½ years. As we stand today it is once every 15 years. That is investment in the network that is driving lower costs and lower faults to the customer. But also we are becoming more effective in an efficient which is affecting CAPEX positively as well in our deployment of our people. I am very pleased to say that we reached agreement with the CWU and our people we took it to the vote, in which there was an overwhelming vote in favour of some changes to working practices, that will allow us to provide much better service in the evening and at weekends, without outsourcing the business. We can now use internal people to provide out of hours work and it will create a significant improvement in efficiency. I am very pleased that working together, actually we get a good solution for our customers, a good solution for underlying economics of the business and for our people. EBITDA as a result of the improvements in cost is up 4%

Now to turn you away from operational stuff to the pension. My favourite accounting standard, IAS 19. I thought I had better explain the constituent parts of what is happening in IAS19. First of all once we have seen deficit that go up, the underlying assets have improved quite considerably since the beginning of the financial year we have seen a 3.3 billion improvement in the value of the assets. Again not a huge shock, the economy has improved market etc etc. But the liabilities have increased by 8.8 billion, that is not because of reassessment of longevity, that was in the numbers at the beginning of the year, it is not because we suddenly have to pay people more money, actually the reason is because of interest rates and what has happened.

Quantive easing it a lot of this but basically we have seen the real discount rates, you have to take the double A corporate bond rate, and take off inflation, that is reduced by 1.56 percentage points. A rule of thumb, roughly 1 percentage point is about 5 billion, a bit under, but that order of magnitude. That has been the big change, it is the discount rate that does it. I know one or two of you were wrong about the IAS19 because you sort of thought that because assets have improved, that your net deficit should go down. It was discount rates that is the difference. We will see how that unwinds and what happens, but IAS19 will continue to be a very volatile number. For those of you, just remember, a year ago, which was not the very strong time for assets, IAS19 actually showed a surplus. That number wasn't representative of the real world. This number I have a similar view of about.

I just wanted to explain that and IAS19 is one of a whole load of valuation methods. Of course it is the accounting one, but as I said it is highly volatile. But also in the course the one that will determine short term cash flow, tri-annual valuation, nothing to report to that. I said that I expected to talk about it and that we should have it settled some time in calendar Q1, because March 30th is a date that trustees and BT come to final agreement, although we were well advanced and we are continuing to talk to the regulator. We do know how much we have to pay and you know that number of 525. You will also see a whole lot of other numbers mentioned. The Pension Protection Fund, that has a number and a calculation. Then you have got discontinuance basis which BT didn't exist. You have to invest in gilts and you would get a completely different sort of number.

But what all these numbers miss…they are not in trying to be an expectant value or a try at the real world. The question I have been asked by a lot of shareholders as I have gone around is; look if you look at the historic returns and apply them going forward, what is the position of the pension scheme? Actually if you looked over the last returns over the last 30 years and apply them over the next 30 years, this scheme would be healthily in surplus. If you looked at the last 20 years returns because you have had a not good last few years, it would be about break even.

The problem with all these valuations, that are done for different purposes, they are done for different purposes and I just wanted to give you a sense of the long term inherent position of the pension scheme and we had an economy in which a mix of assets outperformed double A corporate bonds volumes over the long term, which I assume given you are all equity analysts you would probably expect that to happen.

This is not a scheme which is looking at a massive deficit. That being said, it is big, it is important, it causes a high beta and we will continue to give you details and talk about it so that at least we can all understand what the position is.

Now moving away from the pensions, Network Investment. We gave guidance for more CAPEX and a lot of people will probably say what are you doing less, the answer is we are not really doing much less, we are doing a lot more in some places and some stuff we didn't need to do, we are not doing. But actually what we are doing we are doing a lot more efficiently and probably it is best summed up what is happening on the fibre programme, what we call the NGA, the Next Generation Access programme. We said number of months' ago we expect to have about 750 thousand customers passing them by summer of this year. A few months' ago we said actually make that 1 ½ million, so double it. The programme is actually ahead of plan.

Then a couple of weeks' ago we said actually instead of 10% being fibre to the premises actually we think it is going to be nearer 25% ie 2 ½ times what we expected and we do all of that for the same 1.5 billion that we said we would spend. So as you all know, fibre to premises can cost a lot more, can give speeds of beyond the gigabyte. But we can do that for the same money because we're running the programme better. Also, and the reason I put this on the slide, we are also rolling out some other things, because the whole world is not just about fibre but ADSL 2 plus, we now intend to roll that out to about 75% of the UK. Typically ADSL 2 Plus will double speeds for people. If you are 4 megabytes per second you will probably get with ADSL plus maybe 12 or 13 megs actually or over 10 megs. You will see a number of people will go beyond 10 megabytes per second with that and to get HD it takes about 8/9 megs, so it is an important technology in its own right.

But also it is not just access technology that is important, albeit it is. A lot of it is about data and carrying data and that applies not just to fixed line it applies to mobile and that is why we have been making big investments in Ethernet. I will be honest, two years ago we were behind the curve, we were concentrating in all sorts of things and not actually looking at what was happening in the market, we were behind on Ethernet, we have more than caught up on the Ethernet; we have put in a lot of investment. We are extending to 700 nodes and that is well ahead of the market and it is why we are winning contracts with people like mobile companies to help them with the vast data traffic they are having from things like i-phones and that is something we will continue to try and help people with to manage their data traffic with further investment in Ethernet traffic.

Just a subject on Broadband and Broadband performance, I just thought I would show that EU chart and it shows all the countries in the EU and it shows the UK as the fourth best place overall for Broadband, actually better than France, Germany, Italy and Spain and in fact better than all the big, big countries with the Scandinavians and the Benelux slightly above us. We do well on price, we do very well on the availability, particularly rural availability, we are a bit behind on speed but the investment we are making in fibre will help offset that. So we start with a good position and sometimes you read all these things saying the UK is so far behind; well listen, this is an in depth EU study and it is quite clear that we start from a good position and why? Because the UK is the most competitive market in the world.

Turning now to the future and outlook. I saw somebody said in one of the reports this morning that BT is unusual in giving revenue guidance. I know our revenue guidance wasn't that popular when we gave it six months' ago but I think we got in before the crowd. We said that we expected Revenue to be down. Actually we are probably one of the few people now saying actually it will be down a little less than we thought. I don't think that is because of massive underlying operational improvements against what we expected, it is really because we haven't had some of the movement off our network in the transit revenue and also FX has been a bit better than we expected. So it is broadly in line operationally with what we expected and the underlying position apart from transit getting worse in the second half we are pretty much where we are today.

Capital Expenditure, 100 million roughly off what we expected and again that is really driven by efficiency; efficiency of labour and efficiency of suppliers, Tony will talk about that. Tony will also talk a lot about underlying cost reductions. We said well over 1 billion pounds, we are now saying at least 1.5 billion. So a big step up and given we have done over 900 so far, that guidance hopefully should look pretty consistent with that.

In terms of free cash flow, we said over a billion, we are now expecting at least 1.6 billion. Of course that has been helped somewhat by 200 million of tax in the quarter, but it does represent strong underlying improvement in our business and Tony will talk also about some of the one-off items that have gone the other way.

Net debt, mathematically it is going to be below 10 billion but we just thought we would confirm that as it is now, and tends to just pick up in Q3 before going down in Q4. I think it will be a decent amount below 10 billion. Full year dividend, we thought we were giving other figures, giving the cash flow etc, it wouldn't be our normal practice to give full year dividend guidance for the half year, I just say that in advance, but we thought given all the uncertainty that has been about BT and its dividend and comments in the press all the time about Rights of Issue, let's just say it. We expect dividend to increase this year by around about 5%, consistent with what we are trying to do. What we are trying to do for business is show continued progress hopefully that is consistent because that is the other continued progress and will be consistent also with the fact that we will pay money into the pension scheme and we will pay down a hunk of debt this year, that overall is what we are trying to do, do things for our shareholders, improve the quality of the business and move it forward. With that…Tony.

TC Thanks Ian. Morning. This must be a bit dull for you, no profits warnings, no big write offs. If you look at where we are in terms of the results, I am going to run you through the headline figures and income statements in cash flow and update you on progress and delivering our cost reduction programmes.

Revenue for the quarter was 5122 million, down 3%. Underlying revenue, excluding FX and acquisitions was down 6%. This reflects challenging market conditions combined with lower transit revenues when compared to Q1. The comparative figures for the last quarter was the headline growth of 1% and an underlying decline of 3%. Given where we are in the first half of the year I now expect headline revenue to be in the full year down by 3-4%. EBITDA before specific items and leavers, was 1436 million for the quarter, an increase of 2%. Depreciation for the quarter was 759 million. This is higher than Q1, due to the timing of registering some software assets. We expect depreciation to broadly continue at this level for the remainder of the financial year.

Operating profit was down 6% in the quarter, compared to a decline of 13% last quarter. Net finance expense excluding pension interest decreased in Q2 to 225million. This reflects the lower average net debt compared with the same period last year.

Profit before tax was 461 million for the quarter, down 6%. Leaver costs were down 21 million year on year. This reflects the fact that GS leavers are treated as a specific item in this year. We now believe leaver cost will outturn at around 145 million for the full year. This is 25 million less than the previous guidance.

Pension interest. This is the IAS 19 interest which is a non-cash item. Specific cost before tax totalling 95 million were charged in the quarter of which 49 million relates to the restructuring of GS and 52 million following the recent OFCOM determination on 16th October. Although we disagree with the determination and expect to appeal the decision, we have recognised the charge in the quarter and expect the cash to be paid during Q3. Tax credit for the quarter is 153 million which includes the specific tax credit of 215 million in respect of the settlement with HMRC of prior year tax matters.

The affected tax rate on the profit before specific items was 22.2% which we expect to be the effective tax rate for the full year. Profit for the period was 428 million, some 13% higher than the prior year. Reported EPS was 5.5p for the quarter, compared with 4.9p for the prior year.

Adjusted EPS shown before specific items, leaver costs and pension interest was 4.5 p for the quarter, some 0.4p lower than last year. Free cash flow in the quarter was 705 million, 336 million better than the prior year. I will take you through the component parts. On interest the net payments were 152 million for the quarter, this is broadly in line with the prior year. We expect cash interest in the full year to outturn at around about 940 million. This is in line with the range I shared with you in Q1.

We received 215 million from HMRC relating to a settlement of prior year taxes as previously mentioned. As a result of this and the cash tax received in Q1 we now expect the position for the full year to net out at around about 350 million inflow. On CAPEX there was a net cash outflow of 555 million in the quarter, 22% lower than the prior year.

Changes in working capital resulted in 100million cash outflow, 68 million better than in the prior year. This has been achieved by improving the commercial viability of our working capital and management practices, for example we have reduced the majority of factoring resulting in a 50 million spend in the quarter. The change in `other` primarily reflects the lower pension charge in the P&L not reflected in the cash flow. This is as a result of the pension review concluded earlier in this calendar year.

In addition `other` includes the impact of IFRS 2 rules on share based payment expense and net cash movement on provisions. Net debt of 9878 million shows a material improvement on the prior year figure of 11028 million.

As promised, this slide shows the operating cash flow by line of business. As I said before this is by its very nature maybe volatile quarter by quarter, I would just like to highlight three key things in here. The first is an improvement in GS cash flow which is consistent with our stated ambition to make significant in rows into the GS cash performance, it is our key measure for GS.

Wholesale year on year is impacted by changes in the way we settle VAT with a corresponding upside in `other` and that reflects the two variances in there.

BT Retail, the strong performance is driven by improving EBITDA, lower CAPEX and a better working capital practice as I mentioned earlier.

We turn to cost savings and as Ian mentioned earlier this has been a key area of focus for us. The total savings for the half year are 932 million of which 575 million has been delivered in the second quarter, this represents a really good improvement in the pace of our delivery.

The sustainable capital savings have been delivered by a combination of supplier negotiations, improved efficiency in lower costs for our workforce and more commercial investment hurdle rates. We have also benefited with a one off gain caused by natural timing delay resulting from the introduction of better controls being embedded into the business. It is important to note that while we are delivering long term sustainable savings, we continue to invest in the future of our business.

Given the level savings achieved to date, I would expect our capital expenditure to be reduced to around about 2.6 billion in the full year. In terms of OPEX the level savings has increased in the second quarter. We have achieved three times the level of savings delivered in Q1. Consequently the total cost reductions this full year are now expected to be at least 1.5 billion.

The key components of the OPEX and CAPEX savings are total labour costs. We have reduced the level of labour costs by 461 million in absolute terms and 524 million excluding the impact of FX movements.

Labour cost reduction continue to be driven at different levels of the organisation with savings being identified at permanent staff, agency staff and supply staff directly engaging in the organisation.

I will give you some examples. We have taken out 17% of our third party labour force, on shore and off shore. These savings impact both OPEX and CAPEX given that just under a quarter of our capital costs relate to work undertaken by our own staff. We are well on our way to delivering our full year headcount reductions, these are the targets we gave you at the start of the year.

Supply negotiations continue to go well, we have concluded discussions with just over half of the top 40 suppliers. The savings delivered to date are around about 150 million a year annualised, and it covers both CAPEX and OPEX and we will expect further savings during the course of the year. The savings are based on rate reductions resulting from supplier rationalisation programmes. In GS we have just included our negotiations on our telco access costs in the US with our three major suppliers, this has delivered savings worth tens of millions of pounds. This came in after the quarter and is not included in the above numbers.

We are starting to make progress in improving our circuit inventory management processes within GS but there is still much to do which gives us opportunities moving forward. We continue to focus on our cost base in a forensic manner. This is not about taking 10% of this or 15% off that, it is about understanding exactly where we need to move the cost, focusing specifically in that area and being very targeted in our approach.

This has resulted in savings in a number of areas. For example I will just give you one key example. Facilities management; so basically paying for maintenance within keeping our accommodation intact. That number ran at well in excess of 40 million a year. This year it will be less than 18 million, we will have halved it. This is long term sustainable. For the remainder of the year we are going to continue to improve the profitability of the business and the cash flow, and we are going to deliver it in terms of improving cost savings but the key here is that we will continue to invest in the future.

I will pass over to Ian now.

IL Thanks Tony. Just very quickly, I think we are doing…this is the chart we showed before, I showed that six months' ago, explaining what we are trying to do and it is a very simple thing and it is exactly what we show internally as well which is to start off with better customer service delivery and we are achieving that. To give you a few sort of examples. Our consumer business, we see complaints this half have been down 18% compared with Q4 last year which in turn were down significantly on the year before.

In the SME that is 23% improvement. So that gives you some examples. The number of calls we get into our billing call centre has actually reduced by 20% because the bills are getting clearer, we are getting better, people understand them, but so much more to do in these areas. But that customer services delivery then starts to drive really significant cost transformation. Of course we do the other things like procurement and network management and things like that. But then by driving the cost transformation that starts to free up the resource and allows you to invest in the business. That is what we are doing. As much as the numbers we have quoted you in terms of cost saving are net, actually what has happened, we are saving a bit more and we are investing in some places, but we will continue to talk about net numbers that you can see in the P&L, and in the cash flow quarter after quarter.

All of that I think provides a basis to give a better business. But it is only a basis. Really we have to go from a better business to start to build that better future. That is an area , first of all GS. Global Services is a global leader in terms of what it does, it is not a global leader in terms of the financial results at all and that we have to change and we have to start moving towards that. Hopefully you have seen some of the things, albeit a long journey.

Then the SME sector irrespective of short term issues for the economy, there is a real opportunity, the position is vacant to be the brand for business. Nobody is providing the whole ICT telecoms and converged operation for SMEs. BT is, BT can and it presents a real opportunity and can be a very profitable part of the business as long as you have got the distribution capability and the ability to provide.

In the case of Broadband and net services, I think we are still at the early days of Broadband services, and certainly in Consumer we see a lot of opportunity, TV being high among them and obviously the discussions that OFCOM are having with Sky are a very important part of that, but we see many opportunities for interactivity and to really change the face of TV over time. Also, and we are very proud to say this and probably unusual and pretty much in every Telco in the world, we choose to be a Wholesaler, we are proud to be a Wholesaler and we want to be a Wholesaler that people choose the Wholesaler of choice.

Why? Because we do it well and we understand the difference between retailing and wholesaling and we don't mind helping people to compete in the market place at a Retail level. We are doing that, customers see that, and it is an important part of our business. Also an important part of our business is what we are doing on network. There is a lot of talk in time past about 21C, I like to talk about real customer benefits, what they are seeing day to day. They will see it in fibre, they will see it in investment ADSL 2 Plus, they will see it in investment Ethernet, they will see it in actually what we have done in 21C, and being the best network provider is an important part of that. All these things are the things that will help give us a future. So we are still at early stages but we are trying to build the base and we will try to talk to you next year a lot more about that future and how we are going to build it and what the key parts of it are. In the meantime my job, Tony's job and the job of everyone in BT is to make sure that BT emerges stronger from this recession and I hope that you start to see some proof points of that in this quarter's results.

We would be delighted to take questions from you if you put your hand up.

Question and Answer Session

Nick Delfas,
Morgan Stanley

Two questions, or if I can sneak in a third as well. First of all on CAPEX, the CAPEX of BT used to be above 3 billion, you are now at 2.6, you are investing in VDSL and fibre so presumably without that you would be closer towards the 2 level. That is about a billion reduction. If you capitalise that it would be a pound thirty on the shares, virtually the whole share price. Can you help us understand what that

billion reduction has come from and how sustainable it is? I presume a part of it is GS and a part of it is 21 century network things being completed and a part of it was just wasted before so I would just be interested in what you think the split between those three buckets is.

Secondly, on rating agencies, they can be famously and embarrassingly late adverting to fact, previous views I have seen have been based on GS and obviously GS are now a bit better, but the IAS19 deficit is worse. Have you spoken to the agencies? Do you think there is a chance they will downgrade you based on the IAS19 deficit even though the assets are up?

IL Taking the rating agencies first, we always have dialogue with rating agencies, I have got no insight other than their public statements. I hope they will look at the results and see that we are generating a lot more cash than they had previously thought. But that is up to them. All we can do as a business is run the business prudently but more importantly run it better and I think that is what we are doing just now. In terms of CAPEX I will ask Tony to talk about the detail of it, but I think you are sort of setting up the question a little bit by saying you are coming to over a billion. There are always going to be things in our CAPEX that we, you know if it is not NGA it was 21C. But certainly we have seen a significant reduction, and I wouldn't necessarily put it at a billion, in underlying reduction, but a significant reduction and a lot of that has come from efficiency, particularly from the labour force, particularly in procurement and as you say doing some things we necessarily shouldn't have done in the past.

TC I love your maths, but I don't think it quite adds up. The 3.1 comes down to 2.6, as Ian says there will always be a level of investment so we've made some savings and if you look at the half billion savings that we made today. Four key factors, we have procured more effectively, it is going to have an impact on the capital cost. The second piece and I mentioned this briefly, roughly speaking, just under a quarter of our capital last year was a result of work undertaken by our own labour force. If you make that labour force more effective and more efficient, all the stuff that Steve and his team are doing in Openreach, you improve the effectiveness and the cost of your capital. The same goes in terms of design activities by Al-Noor, same impact. Make people more efficient, more effective it impacts through.

The third piece is, undoubtedly we didn't spend in the right way and there were things that were done that we shouldn't have done, we were technology-led, not market-led. I made that point previously and this is all about ensuring we get a return from the capital for a market perspective not from a technology-led business perspective and that has an impact by putting in high hurdle rates you reduce the capital. The last piece is we get a one-off benefit – as you put in better controls in the business, by default as the business comes to terms with those controls, there is a small period whereby I wouldn't say it is inertia, but there is a little bit of a delay built in. That is why if you look at the capital spend in the first half of the year compared to the second half of the year there is an uplift on there.

Stephen Howard, HSBC

Just further on that point about CAPEX, perhaps you could just talk us through what has changed to persuade you to build out more fibre to the premise as opposed to fibre to the node, fibre to the kerb?

Secondly, a strategic question I suppose on BT Vision. It does look like your customers are really enjoying the on demand capability but plainly you are not the only people who are going to be able to offer that going forward, in a year or so with things like Project Canvas and it is going to be a lot of opportunity for a lot of over the top providers to deliver that type of service. How should we think about BT Vision's positioning in that market going forward? Do you see yourselves as a viable long term brand in terms of the provision of content? Or are we better off thinking of you really as a pipe with that as a bolt on?

IL

Or neither of the above. In terms of FTTP, I think the answer is because we are getting better at…we are finding ways we can deliver things more efficiently and effectively, is why we think we can do more fibre to the premise. Steve, do you want to add anything on fibre?

SR

The deployment of fibre to the premise and the targets around that are based on the experience that we are gaining in our fibre to the cab roll out. So as we always said that this was going to be a learning process, I think the mix was always something we said we would adjust as we went forward and, as we get more experience, as we learn, we can see ways of utilising our existing topology to deliver fibre to the prem in brownfield sites much more effectively. That is going to be refined between January and March this year where we're going to go out to a place in Milton Keynes, Bradwell Abbey, also a place in North London where we will do some brownfield fibre to the prem trials and this is going to be an evolving story.

TC

Just let me add one thing. The unit cost of servicing fibre to the premise as opposed to the cabinet is much better and much lower. That is another factor.

IL

In terms of Vision, I will pass over to Gavin in a second, but we are very enthusiastic about Canvas, we think it could give many opportunities and we certainly don't... over the top providers are somewhat quite different from people who are providing a true integrated service.

Gavin, do you want to talk about some of the plans a bit more?

GP

On Vision, customer wise we believe there is plenty to go for still, we are not at the sort of levels that we want to be, we want to be able to count our customers in millions and not in hundreds of thousands. But what we have learnt I think is that when customers have the service, they use it a lot. We have seen the usage increase quarter by quarter. If I look ahead to next year, there are a number of initiatives coming through, we have an HD box coming through next year, we are big supporters of Canvas and Canvas will distinguish ISPs that support it, and hence provide a quality of service guarantee, and you can read that as a TV like experience, that will be very different from those who just go over the top where there will not necessarily be any guarantees around quality. So we are a supporter of it, we are part of the alliance that is trying to get the support of the BBC Trust at the moment.

Then I think the third thing is we remain hopeful that Ofcom follows through on its initial consultation around premiums. We see an opportunity in the TV market for customers who want premium sport ,for example, but don't really want to pay for basic TV channels at the same time. I think there is a lot to go for in TV and we do see it as critical to our future.

IL

We also think there is a good opportunity in our Wholesale business around this in terms of content distribution and we are also investing in content distribution and because as befits our view of wholesaling; we'll help other people to distribute TV content and we would expect as a wholesaler to make money out of helping other people, as many wholesalers do. So we are investing in that and that will help not just our Retail business but elsewhere.

Mike Williams, ICAP

A couple of quick questions. I just want to check my understanding on the IAS19 deficit first of all if I can. I think you used the delta between index linked and government bonds as a measure of inflation. I guess the question is do you think that the current yield on the index linked bond at ½ per cent is a fair reflection of real yields? It seems to have a lot more to do with the current uncertainty in the market place and QE as you mentioned. Can I just check my understanding that if we were to use a more normalised inflation assumption, of let's say 2 ½ per cent, it would take roughly a third off your IAS19 deficit?

Secondly I just want to on the paid leaver scheme, you are clearly getting more bang for your buck with regard to the scheme, could you just clarify the outlook for it beyond the

current year I have been hearing some rumours that maybe it was going to be stopped or suspended and I would just like to understand the impact on headcount reduction and leaver costs going forward beyond 2010? Thanks very much.

IL

Okay on leavers, yes we have suspended the current scheme, we have had a big influx of people interested in the current scheme, we will look next year about what scheme is appropriate, if a scheme is appropriate or whether there are other ways of doing it, we do think there will be leaver costs next year however and they will be significant, probably less then this year, but they will be significant. In terms of pension, I would have to do that calculation, I am not going to…I can't forecast equities and I am certainly not going to try and forecast bonds. I will leave that up to you in terms of the inflation assumptions. But basically as a rule of thumb a quarter point movement in the discount rate is…well as I said, 1 per cent is a bit shy of 5 billion so you can do the maths from there as to what it gives you.

But am I right in the methodology in terms of the way in which you calculate inflation? You have got…

IL

…regretfully it is marginally more complex than you just said, but we would be happy to explain the formula which involves a lot of one and x's in it. The IR team, I can see their enthusiasm to sit down with you about it. As a serious point Mike, we can take you through that and you can work that out.

Petri Allas, Redburn

Just a couple of questions if I may, first on Wholesale, you have obviously been very successful in selling to mobile operators, four out of five if I understand is the wholesale transport. But now there is a scenario that it consolidates to two networks in the UK. What sort of impact would that have on your Wholesale business if that was to happen over the next few years?

Second thing, Retail angle to the FTTP/FTTC as to any new updates on the possible demand premium etc that you have seen from your early trials? Is it of interest in the Retail end at the moment?

Also because historically you have rather been selling national products and now what you are saying is sort of pick and mix depending on circumstances, is there any complexity in Retail marketing different products between different streets?

IL

Answer to that last point is yes, it does add complexity but also we do a lot of direct contact with customers. Way too early on trials to say things. Yes, there is demand but of course there should be demand given the fact that we are…it is big local news and it would be surprising if there wasn't and we are quite happy with that.

The first question was about the consolidation effect on Wholesale, I will ask Sally to add to it, but the answer is if they consolidate around us good news, if they consolidate away from us less good news.

SD — Thanks. Yes, consolidation always brings challenges as well as opportunities, but we are very strong partners with those customers, Vodafone, O2, Orange, we also supply quite a lot of access to and also T-Mobile, the MBNL joint venture. So we are well placed with all of them and we are working actively today with Vodafone and O2 on their site consolidation. So I think we are well placed, we will have to see how that evolves, but we certainly think we will factor this into the future

Steve Malcolm, Evolution — **I have two questions, one coming back to Gavin's comments on Pay TV. I wonder if you could give us a bit of colour on how, if Ofcom proceeds the way we think it will in forcing a wholesale must offer on Sky, would you consider trying to sell the service before an appeal to the CAT, before a change of Government, and also how would you do it? My understanding is that there isn't any DTT spectrum out there. Would it be exclusively IPTV and how would you map that into your fibre roll out plans?**

Secondly a boring numbers question on working capital, your payables are 50% bigger than your receivables, your revenues are shrinking, why do we not think that working capital is a drain off the current efficiency gains washed through? How can you give us better confidence that the working capital won't suck some cash out over the next few years?

Gavin — If it is available we will retail Sky Sports and Sky Movies and it is a very tight call to say whether or not it will be available or not and whether or not I would expect Sky to challenge that. The advice we are getting is that we should be able to get it before it goes to the CAT if they choose to challenge it. But I would like to wait and see before I commit to that.

We are looking at DTT, there are options for us in DTT. So we are looking at that as a way of distributing before we do it across IPTV.

SM — **Could you get HD on DTT**

GP — We can in 18 months time.

TC In terms of working cap numbers, if you look at the first six months of the year, we have unwound some of the things that were undertaken previously, we have unwound, for example, that were not commercial sensible, so we have unwound factoring, so therefore, that is about 50 million or so. If you look at it in terms of what we are projecting for the full year, there will be 100 million unwind in relation to, I would say, poor practice of what we did previously. If you look at it moving forward, I would expect the working capital to improve, simply in terms of what we are doing in terms of the business, the overall impact in terms of working capital. It will not continue to be the drain it has been historically.

IL The gap is more to do with, let's say our sort of volume business as it were. In GS actually what we have had is a negative working capital situation. You know, that won't suddenly get better next year but over time that will do. As you say there is some movement the other way. But working capital has been a big drag in our business over the last few years and there will be a point where it starts being less of a drag and maybe doesn't be a drag at all.

TC If you look and see that the profile of the GS contracts, historically we have been in a position where we have been deferring expenditure, follow that through in terms of the EBITDA position and the working cap position, it means that your working cap is getting worse because of that. That flow out of cash, through the deferment of cost and the accounting treatment of that means that it has impacted the working capital position. I would expect that to improve as we went on.

Paul Howard, Cazenove **Just following on on a cash flow question, as we look into next year there is obviously going to be a big turnaround on tax, should we expect cash flow to step back next year after this year? Perhaps sort of looking forward, without putting any timing on things, do you feel that you can recover the historical levels of operating cash flow that the Group has reported in the past?**

Secondly, just on revenue, three to four per cent decline for the year, what does that assume in terms of the underlying rate of revenue decline?

IL On underlying revenue, there is not going to be a huge impact in the second half from FX, or if there is then it is going to be different from what we expect. In the same way I am not going to completely be good at forecasting bond yields and equities, I am probably not going to go into FX or else I will be doing all your jobs. But encumbent in that thing will be a slight drag, about neutral from FX as a result of that in terms of…so the underlying won't be that different from the second half sort of numbers.

TC The exit run-rate where we are now on the underlying revenue, to get to where we are going to be, if you work the maths through, it is an extension of the existing exit run rate and that will flow through on underlying.

IL The other question you asked for, in terms of that, I think Paul, you obviously have got to do your numbers for next year, but the way to think about, whilst there has been a very favourable tax effect we have also had a number of one-offs and specifics and if you sort of said, okay, what is the underlying operational position of the business just now, if we are giving guidance on something more than 1.6 billion, there is probably net of the tax one way and then specifics and some working capital adjustments we have made to give ourselves a permanent base, I think it has moved. You have got a net of all of that 150 million or something of that region in our favour, so you are down below 1.5 billion, shall we say instead of the 1.6. Next year there will also be some specific items as well but then you have to decide …the specific items will next year be a bit lower, but they will be quite a lot, and then the business should improve. You have got to work out where the net of that goes. It is a big number to make up in terms of some of the things because we do have…our underlying position will still be better than it's showing next year in terms because we will still have specifics so in the longer term, actually BT's cash generation I think looks quite strong, of course pre-pension all these items.

Robert Grindle, Deutsche Bank **Just on the higher D&A, is that a temporary thing or is that something that is going to continue at the higher level now, going forward? Within the annual OPEX savings this year, what is the renegotiation of the pension scheme worth within the total?**

IL Pension worth about, in the OPEX, about 100 million. In terms of depreciation, short term and then I suppose a long term will look different.

TC Short term will be a continuation of the exit rate that we had in Q2, you can work that through. It comes out at just over 3 billion. Next year around those sort of numbers, but you know, again a question in relation to Paul, we will give next year's guidance when we give next year's guidance.

Hannes Wittig, JP Morgan **I have two questions, first you have already said what you are doing on the CAPEX side, I just wanted to get an understanding, within all of your cost savings that you are achieving this year, what is the element of exceptionality? You said a bit of latency in the CAPEX, there is probably some squeezing of suppliers maybe? Surely a wage freeze? Out of the total savings how much of it is going to be recurring, how much of it is maybe a bit of an**

emergency measure this year given where the business was a year ago?

What should we expect from the pension review that is different from the 525 million agreed funding contribution? Could there be a one-off payment? Could there be a statement that the pension deficit is higher or much lower than IAS19? I just want to philosophically understand what is going to result from this that is different from the hard cash that you have already committed or if you have a fluid contribution over the next three years?

IL

Philosophically on the pension, philosophically the 525 is the 525. Philosophically about what the agreement between the Trustees, the company which we are pretty advanced and the Pension Regulator might come up with, philosophically we will tell you probably at sometime around about March when it is meant to be settled by. There is nothing really more I can add, except to say that I have no idea whether they will be higher or lower than the IAS19 and no idea what the IAS19 will be at that point because of the way it bounces around and I don't think it really should underline matter. The strange thing of course is because we have the 525 settled, that it is actually the following triennial valuation that is going to be more important than this one in a lot of ways, but we will just have to see where it goes. We will give you the number when the number is decided.

TC

In terms of the cost savings, fundamentally I do not believe and I will not undertake any supplier and negotiations that look at one-off payments to be made. We will not take one-off receipts, don't believe in it, we won't do it. So the savings we have delivered this year, there is none of that one-off gain, it is long term sustainable in terms of supplier savings. In terms of what we have done in relation to the labour force, sure, we have had you know, there has been a pay freeze within BT, will that be unwound? No, it won't be unwound, because once it is there, it is there and it flows right the way through. The savings that we have are long term sustainable.

Maurice Patrick,
Barclays Capital

Just on the cost cutting side, 16% reduction in the wage bill, I think it is 12% of the direct bill, can you help us understand of that 12% how much is lower head count and how much is lower wage cost for employer, I know you have got the tail wind through lower wage increases, the pension etc, help us break that down?

IL

Well we said that the pension was about 100 million in the year, so that gives you that number and we said that last year we lost about 15,000 people and we expected to do broadly the same this year, we are running…we have done a lot in the first half of that. If you just follow the maths through from last year's total pay into this year and the wage freezes, of course the wage freeze is not a reduction, it is an absolute, so you know that gives you the key answer. What has been very important for us, although it is not in direct numbers, is that we have been doing a lot to reduce third party agency, contractors and redeployment. We have had literally thousands of people that we have managed to redeploy from one part of the business in to another, which meant, I believe very strongly that we have a real duty to people who have been 10 or 15 years in BT to try and find another job and that is what we are trying to do wherever we can do and so we have got ex-engineers going in helping in the call centre which means we are using less third party contract call centre resource and you know re-training is a really important part of what we are trying to do.

Michael Armitage, Astaire Securities

You made a very convincing case for looking more benignly at the pension deficit in terms of looking at 30 year returns on assets. Could you tell us, is that the thinking that you are feeding into the, and I am sure it is not, feeding into the discussion with Ofcom as far as Openreach recognition of pension costs? How do we square those two discussions?

IL

The Ofcom one isn't about paying off a deficit, it is about the cash flow that relates to the pension, that is the critical thing, and you know as in turn how much money do we have to put in and that…there are discussions around that. If that means in ten years time, because actually the pension scheme performs better than the trustees have assumed, and by the way the trustees always, always should assume a downside because that is their job, then it might be that there is a credit effectively flowing through to the overall numbers and that would be fair enough if the pension paid…because if you look the 100million pounds we are paying less into the pension scheme as a result of the renegotiation with our employees, that flows through into the underlying cost and into the the regulatory stuff. We just think the special payments should also do the same, and it becomes absolutely a two way street and judge it over time which is perfectly fair.

Laurence Sugarman, ING

On Global Services, one of the concerns that I think people had is in terms of price negotiations by your customers going forward. Could you just give us a little bit of a picture as to what is going on in terms of renegotiation on some of your bigger contracts?

Secondly, just in terms of volume of minutes, I think one of your competitors was suggesting that minute volumes have been under pressure, but there are some signs of stabilisation. Could you perhaps comment on that?

IL I am not a great fan of the green shoots argument, I think it is a very dangerous thing for a CEO, so the numbers are what the numbers are. We give you very good KPIs and you can see them. In terms of pricing, yes there is pricing pressure unquestionably and GS have absorbed, will absorb and I think it should be recognised in the offset that there are a lot of things happening in GS. If they had a consistent price situation to do it against the back of, we would have seen a stronger improvement. We would see a stronger improvement in the future if it was consistent prices, but as we go in to renegotiate contracts, if the price goes down our job is to make sure we do more for the customers as well. But you know, we are in an industry that has historically been deflationary and I don't think that is going to change overnight.

On the flip side, our customers are more network reliant, are going to use more data, client service is going to be more important, and security is going to be more and more important. Yes, but in all of this our job is to make up for the fact that the fundamental price does continue to go down and certainly we will continue to see that. Hanif, do you want to add anything about prices to customers? Apart from it being great value?

HL I think Ian covered the point on re-signs, I think that on new business certainly there are some customers who are looking for dramatic reductions and I think that the key focus for us is to look for the right quality deals and look for the right capabilities. So I think we are more selective on new deals where we can deliver and where they can make incremental cash for us, as well as incremental profit. I think that at this point in time, given the environment, there are certain customers who are looking for dramatic changes and to be honest we are staying away from those scenarios because it just creates a bigger issue in future years.

Nicolas Didio, Exane BNP **I have one question on Global Services. I know you don't give a guidance but considering the recent improvements do you have now better visibility on the normative profitability of GS in the long term considering that C&W and FT are doing much better? Do you have a better visibility on what you can do in the long term?**

IL Well I won't discuss the comparatives as to whether they are doing much better…I showed a discipline that was unusual for me! In terms of, we know what we expect to do, but we have said very clearly and you say in your opening line, I know you don't want to give long term guidance for GS. Bang on - we don't deserve credibility for long term guidance for GS. Our job is to deliver and when we deliver we will talk about delivering and how we are doing and then we will see how we take it from there. Proof points, that's going to be the important thing.

Michael Kovacocy, Daiwa

A quick question, you have spoken about ethernet, wholesaling and mobile. With the upcoming spectrum next year, the spectrum auction, do you have anything to say on this?

IL

Yes we will see if it happens next year, the spectrum auctions have always taken longer. We would, as always, would look at spectrum and we will certainly be pushing some of the suggestions in the Digital Britain proposals such as giving indefinite licences for 3G, seem to us to be wrong and also seem to be taking money from the Exchequer at a time when the Exchequer could really do with some money. We think how you could do the whole of the…large chunks of the UK could be fibred with that sort of money coming from re-auctioning 3G licences rather than giving indefinite licences, even though there are ongoing payments. So when they actually finalise what exactly is happening we will look and see if there is interest but also, we continue to work very closely with the mobile network operators particularly Vodafone just now in terms of having them as a wholesale partner and what you are seeing more and more is the mobile companies using us more and more to provide them with wholesale services. I also don't object to us using the mobile companies for wholesale services, just as long as those MVNOs are available then that might be the best route. Because, what is a mobile network today is a bit of spectrum, mast and then it finds a fixed line. You know, it is not unlike WiFi in terms of the overall structure and I think one has…part of the future world and maybe some people still have to learn this is about being able to work with people who are your competitors in other fields and that is why we are keen to be a wholesaler and we don't mind being wholesaled to.

[End of Questions]

I think we are done there, thank you very much everyone and I look forward to seeing you in six months time.