BT GROUP PLC

Q1 2013/14 RESULTS CONFERENCE CALL TRANSCRIPT

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Company speakers:	Ian Livingston	Chief Executive
	Tony Chanmugam	Group Finance Director
	Gavin Patterson	CEO BT Retail
	Liv Garfield	CEO Openreach
	Damien Maltarp	Director, Investor Relations

Damien Maltarp

Slide 1: Thanks, and welcome, everyone. My name is Damien Maltarp, and I'm the IR Director for BT. On the call today, we have Ian Livingston, Chief Executive, Tony Chanmugam, Group Finance Director, and Gavin Patterson, CEO of BT Retail.

Tony will go through the headline results and financials, and Ian will go through the lines of business. Gavin will then say a few words before we hand over to you for questions.

In the room with us today, we also have the CEOs of our other lines of business.

Slide 2: Before we start, I'd like to draw your attention to the usual caution on forward-looking statements. Please see the slide that accompanies today's call, and our latest Annual Report and Form 20-F for examples of the factors that could cause actual results to differ from any forward-looking statements we may make. Both the slides and the annual report can be found on our website.

I'll now hand over to Tony.

Tony Chanmugam

Slide 3: Thanks, Damien; and good morning, everyone. Thanks for joining the call for our quarter 1 results.

Overall, we've delivered a solid financial performance, and despite the impact of regulation and the investments we're making in BT Sport, we've grown profit before tax and EPS. This quarter's performance underpins our expectations for the year, which are unchanged.

Before we go into the detail, I'd just like to remind you that we've revised our financial and operational and disclosure in June. This quarter's numbers and their prior-year comparators are on that new basis.

We made the change to simplify our reporting, and to make it easier for you to better understand the differing moving parts of the business. While we recognise that you've had to rework your models, we hope you feel this is an improvement, and I'd like to thank you for the positive feedback we've had so far.

Slide 4: I'll start with the income statement on slide 4.

Headline revenues were down 1% in the quarter. This includes the impact of a £51 million decline in transit revenues, which is broadly offset by a £32 million favourable impact from FX, and a small benefit from acquisitions.

This meant that our main measure, underlying revenue, excluding transit, was also down 1%. This was largely due to the impact of regulatory price reductions, as I flagged to you last quarter. But as I also mentioned, there will be a degree of quarterly volatility in our revenue trends.

Underlying costs, excluding transit, declined by 1%. This was lower than previous quarters, but in line with our expectations, as our cost transformation was partly offset by the impact of BT Sport, which contributed to a 1% decline in EBITDA.

Depreciation was down 4%, reflecting our capex efficiency over the last few years. This led to operating profit growing 2%.

Interest declined 14%, mainly due to lower net debt and a lower average interest rate. This led to profit before tax and adjusted EPS growing 5%. Specific items were a net charge of £114 million. This included £84 million of restructuring charges on our group-wide programme, and net interest on pensions of £59 million.

Slide 5: Turning to free cash flow on slide 5. Our cash flow tends to be negative in the first quarter due to the phasing of some of our supplier payments and the timing of bonus payments to our employees. This quarter, normalised free cash flow was an outflow of £60 million. This was an improvement compared with our last year, largely reflecting lower tax.

Historically, we've been prudent when making our tax payments on account. Having finalised our historic tax positions, it's been recognised that this resulted in some overpayments and, therefore, the tax payments in the current year have been reduced. This is what drove the lower tax in the quarter.

Our cash flow also benefited from lower cash capex, although working capital was a larger outflow this quarter. These were both due to phasing in the year.

Our normalised free cash flow guidance for the full year remains unchanged at around £2.3 billion.

Below normalised free cash flow, we had a £20 million cash tax benefit from pension deficit payments.

Specific items were an outflow of £134 million, mainly relating to restructuring costs. This meant that reported free cash flow was an outflow of £174 million in the quarter. As a result, our net debt increased over the quarter, but is down by over £1 billion since last year as we continue to focus on net debt reduction.

Slide 6: Moving on to our costs on slide 6. This quarter, underlying operating costs, excluding transit, were down 1%. This is a smaller reduction compared with previous quarters, partly reflecting a better revenue performance, but also because our cost transformation was partly offset by around £40 million of investment in BT Sport and a £13 million increase in the non-cash pension operating charge.

On an underlying basis, and excluding the non-cash pension charge, our costs were down 3%.

At our Investor Day in May, I went through a number of the cost transformation areas that we have focused on. These include process reengineering, procurement, and generating savings from insourcing. We've continued to make good progress on these in the quarter, but have also indentified further opportunities.

For example, when customers in Global Services cease a circuit with us, we don't then cease that circuit quickly enough with the other network providers, leading to a backlog in this process. This is costing us over £2 million a month. We will cut this out by reengineering the processes and reallocating resources.

Let me give you another example. We currently spend over £120 million a year on management and support activities within our call centres. However, the levels of overheads vary between the business units. So if we can spread this best practice, there's a c.£20 million opportunity to improve efficiency and reduce the cost base.

So there are plenty more opportunities across the business, and I genuinely believe if we execute well, we can make further material savings.

<u>Slide 7:</u> Turning to regulation on slide 7. Two weeks ago, Ofcom published their LLU & WLR charge control consultation which will run until September. This included proposals for revised price controls for the three years from April 1 next year.

We're reviewing these proposals, but it's worth highlighting that there are a number of areas where Ofcom has not fully recognised the cost of providing these services, for example, in relation to broadband line testing and fault rates.

We'll be doing further analysis, and if they include these costs in the final statement, we would expect this to help the final outcome.

In addition, they're examining what the right service level should be, and we expect them to move from using an 2011/12 cost base to a 2012/13 cost base. Both of these should also improve the final outcome.

In the Fixed Access Market Review, Ofcom confirmed it sees no current requirement to regulate wholesale fibre rental pricing. We have a long payback period on our investment. Our eetail and wholesale prices are already amongst the lowest in Europe, and Ofcom's proposal recognises that the pricing in copper broadband will act as a check on fibre prices.

Ofcom also provided further guidance on how it would apply existing ex ante margin squeeze powers. We're reviewing these proposals, but they appear to be broadly in line with our current understanding of how the test operates.

The Wholesale Broadband Access charge control consultation was also published recently. Ofcom proposed increasing the unregulated area from 78% to 90%, while the remaining 10% would now be subject to lighter regulation.

<u>Slide 8:</u> Turning to a few other areas on slide 8. The IAS 19 deficit at June 30 was £4 billion net of tax. This is an improvement on the last quarter's figures of £4.5 billion, reflecting the higher real discount rates which more than offset lower asset values.

This is probably higher than some of you may have thought given the movement in bond yields, but this reflects the fact that our actuary uses a yield curve to determine the discount rate rather than just an index yield.

As announced in quarter 4, we'll be continuing our share buyback programme through this year and next. We'll spend around £300 million this year, and during the quarter, we bought 25 million shares for £75 million.

<u>Slide 9:</u> Turning to outlook on slide 9. Our group outlook for the year is unchanged. There are a few things I want to point out around the phasing during the year.

As we said last quarter, we expect EBITDA in the first half to be impacted by upfront investment in BT Sport. In the second quarter, we expect this to impact BT Retail EBITDA by around £100 million year on year, including programme content costs which we will start to recognise.

In BT Global Services, we expect a smaller benefit from contract milestones in the second quarter compared with the prior year, with this reversing in the third quarter.

And finally on Wholesale, you may remember in Q2 last year, the Court of Appeal ruled against ladder pricing. This meant we stopped recognising any revenue from ladder pricing and reversed out the £24 million of revenue and the £11 million of EBITDA which we'd recognised in quarter 1. This year's Q2 year-on-year performance will, therefore, benefit from an easier comparator.

Overall, from a group perspective, we'd expect a larger decline in EBITDA in Q2 than in Q1, but that an improved performance in the second half will deliver our EBITDA outlook for the year of £6.0 billion to £6.1 billion.

With that, I'll hand over to Ian, who will take you through the lines of business.

Ian Livingston

Slide 10: Thanks very much, Tony. I'll go through the line of businesses, as Tony said. Before that, turn to the slide 11, just to give you an overview of the position.

Slide 11: We were pleased with these numbers. They are ahead of market expectations for revenue, EBITDA, EPS, free cash flow. And also, we think the operational metrics are good. There are some very encouraging numbers in there.

Q1 is in line with our full-year expectations, and positions us well for them. I think BT Sport is worth calling out. It is still very early days, but we are very pleased with the strong start.

So across the pitch, we're making good progress, both operational and financial. But of course, I said it before and no doubt it will be said again, there is still a lot more to do.

Slide 12: Now turning to lines of business; Global Services on slide 12. Underlying revenue, excluding transit, was down 3%. That was in line with Q4, but better than the three quarters before then.

Continue to see similar trends; double-digit growth in Asia, Latin America, excluding FX; and Southern Europe, actually a little bit better than it has been, slightly better numbers in Europe. But overall, a better performance from Global Services in revenue terms.

I think the standout number perhaps was order intake, £1.7 billion, up 49%. Now that was impacted by one or two large deals. We had a particularly large contract renewal with Credit Suisse, but also some good deals with companies such as Arla, maker of Lurpak for instance; the EU, NATO, SocGen. So thank you to those of you listening in; Credit Suisse and SocGen, thank you for the business; very much appreciated. But a good level of order intake, and you see from the chart on the right-hand side, it is moving the annual total up.

Underlying operating costs, excluding transit, down 4%. Clearly, our aim is that this number should improve more than the revenue position and that's the way that we'll get earnings up.

Underlying EBITDA up 1%. The statutory EBITDA is up 6%, but the impact of FX was a positive one on profits, so we want to make sure you understand the underlying EBITDA was up somewhat less than that.

It was, however, impacted by milestone recognition. It's a comment we made in the results. And whilst it's not huge in total group results, it does affect just the quarterly phasing of things. And there was less benefit recognised this quarter compared to the same time last year; a few tens of millions. You're going to see something similar in Q2. Yet in Q3, you have a benefit going the other way. That is in the nature of the volatility of quarterly numbers.

Operating profit more than doubled, so now again solid operational profit. But, of course, our ambitions for Global Services remain significantly more. And we have the usual seasonal cash outflow in the quarter. On a quarterly basis, probably it's doing that. The number to look at is EBITDA less capex, which was up £28 million.

Slide 13: Now turning to Retail. Retail revenue was flat for the second quarter, made up really of three parts of Retail up and Consumer marginally down, Consumer down 1%. Still a much better number than we've had historically. Calls and lines, down 5%; but strong growth in broadband and TV; revenue up 9%.

Business revenue, best for four years, up 1%. And really, it still had a decline in traditional calls and lines. I think that reflects the market rather than how it's doing in the market. But IT services revenue up 9%, which is a good performance, and I think if you look over the quarterly performance in BT Business, you see a continual trend of moving from mid-single digits negative to positive.

Also, in Enterprises, we saw growth again, and also in our Irish business, both inc and ex FX.

Operating costs were flat. Now that's not because Retail's given up on cost transformation, but that reflects the £40 million of costs into Sport. Without that, of course, we'd have seen some decent cost reduction.

And a similar story on EBITDA. EBITDA would have been a good positive number, but we are making investments, and that's something that we knew we would do and did talk to you about in advance.

On the operational level, Consumer line loss, the lowest for five years. And that's particularly good because Q1 is a quiet quarter and, actually, all other things being equal, you would expect greater losses in that quarter.

Broadband, 50% market share of broadband net adds. On Q1 last year, that's up 12%.

Retail fibre on a similar basis, up on Q1 last year; i.e., adjusting for seasonality; up 30%, 197,000 net adds. We've now got around 1.5 million retail fibre customers, so that's over 20% of the retail broadband base.

BT TV net adds, 23,000 net adds; more than it was in Q1 last year. It would have been somewhat better but it was impacted during the quarter. We stopped providing Sky Sports on DTT and we did lose some customers as a result of that. It was something we knew we were going to do and had to do and, obviously, will seek to providing it through other means, but that did impact the overall net adds.

Slide 14: And of course, turning to Sport. Well, it does launch on August 1, so got a little while to go but it's coming very, very soon to you. So if you haven't yet signed up, you really should do. We've now over 0.5 million people who've signed up. It's ahead of our expectations so far, but it is, and I stress, very early days

We also announced the games we'll be showing in the first third of the season, and on the chart we show a number of them; some big games, Chelsea/Spurs for instance, Everton/Liverpool, Spurs/Man United. And actually, there's a bit of a mistake on the chart because it's missing the really big game of the season, Aberdeen/Celtic on August 17 we'll be showing, so make sure you put that in your diary!

Actually, and there was a lot of talk at the time the picks were announced, about the early picks, actually, we expected Sky to use the first picks in August and really try to take a position in the first games of the season. And that's absolutely fine, because actually, what it means is in terms of first picks, we've now got more left for the rest of the season, and I think we'll particularly see in the second third of the season a really particularly strong programme from BT because of the way the picks and our rights work.

We also announced the new four-year contract on the FA Cup so it adds to our existing year's contract, and that, for instance, means that we will be showing exclusively the Community Shield. So that's a good early season thing to have starting next season.

So there's a lot happening. We've announced new rights whether it's Conference football, for instance. We've also got our studios open. We've got a grand opening of our studios tomorrow night and that's been put together in record time. Some of the most advanced and best operational studios that we think anywhere in the world, and it actually shows the speed that we can do things at. They've been built in a real record time. So, so far, so good on Sport.

Slide 15: Moving now to Wholesale. As Tony mentioned, mentioned ladder pricing, it continues to affect the year-on-year numbers, and therefore in the commentary here, we've tried to give the ex-ladder pricing because, of course, it will be dropping out of the comparatives soon.

Excluding ladder pricing, underlying revenue excluding transit up 2%, so that again is encouraging. And one of the things we said about the way that BT will grow is that you'll start to see individual bits of the business starting to grow. We've seen it in BT Business, for example. We're seeing it in Enterprise. We see it in Ireland. We see it in Wholesale.

On the same basis, EBITDA up 3%; again, a big improvement from a couple of years ago. Operating costs are up; operating costs ex transit up 1%. And that reflects something I've mentioned a number of quarters which is there is a mix change in Wholesale. So it's a slightly higher cost of sales in the overall mix and that affects its overall cost base.

Order intake, another very strong quarter over £500 million, so keeping the £2 billion run rate for the year in that quarter. As we said, it was a particularly exceptionally good year last year. Probably the standout contract in this is with ITV for the UK digital broadcast net that we'll be providing them. So I think some pretty reasonable Wholesale numbers.

Slide 16: And turning to Openreach. Now revenue is down 2%, and what we've tried to do is show you on the right-hand side chart what the trend has been including and excluding regulation. It's not because we don't think regulation is one of the occupational hazards of being in our business. But I think the scale of the regulatory intervention has been particularly significant over the last year and this year.

And as Tony said earlier, we would expect and we'll be pushing for that to narrow quite considerably in future charge controls. And you can see this is the cost that has been taken in Openreach, £60 million, and the impact, if you add £60 million to both the revenue and EBITDA, you can see the impact it does actually have on the regulatory changes.

Outside regulation, we've seen fibre revenue more than double, so fibre is growing very nicely; and, of course a lot more to go there. Ethernet revenue up 5%.

Operating costs were flat. Now there has been a number of efficiency savings in Openreach, but there has been additional engineering resource brought in. Fault rates, for instance, are high, a combination of the weather and also with broadband, the more speed you put down broadband, it does cause more intolerances in the line and more engineers to be sent out. And that's certainly a point we've been making regarding the regulatory price reviews. I think we have to recognise that a lot more is being demanded of our network in terms of speed and capability.

I'm delighted to say this quarter a 12,000 increase in physical lines. That compares same quarter last year we were down 44,000, so quite a turnaround. So up 110,000 over 12 months, which probably reflects continued people searching for fixed line broadband. But also, there probably is an element of housing formation in there. I think as you get more household formation, that should, all other things being equal, be positive for line growth. And one of the things about the UK is I think it can look forward to more housing formation than perhaps some other countries in Europe.

Slide 17: Now turning to fibre, it continues to be a good news story for the UK. The UK is now in a much better position than, for instance, our European comparators. Over 16 million premises now passed, over 1.7 million now connected. As you know, we said about 1.5 million retail.

What we are seeing is on one hand, the number of premises connected have doubled year-on-year. But also a significant increase in the rate of connections from third-party providers; for instance, in the quarter we've just announced, 3 times what it was this time in the same quarter last year.

So we are seeing both Retail doing well, but also very strong growth in third-party providers, and that's something we expect to continue.

On BDUK, if you look at the chart on the right-hand side, those show the contracts we've signed, either BDUK or other similar type regional and rural contracts. 29 to date. We're working hard on them, and there were nine contracts signed in Q1.

We'll continue to push in terms of rural availability and our belief is that we can deliver fibre to well over 90% of the country, and that will put the UK in a very, very good position. It's a long-term investment for us, we know that, but we think it's the right thing in the future of BT, but actually, it's also the right thing for the UK.

Slide 18: So in summary. Well, first of all in summary, I just want to say thank you to all of you. Thank you for generally your support over the last few years and thank you for your interest. It is very much appreciated and I do sign off on my last quarter review with somewhat of a heavy heart.

But we've made a lot of good progress and I'm delighted to be going at a time when there's just a huge number of opportunities for BT. I don't think the future for BT has certainly looked as exciting since I've joined about 11 years ago.

There's a great team; the whole team, you know the top team, you've seen how good they are, but the whole BT team. And I'm sure under Gavin we are going to go from strength to strength.

And on that point, probably the best thing to do is to pass over to Gavin maybe just for a few words. Gavin.

Gavin Patterson

Slide 19: Thanks, Ian. I just wanted to say a few words about my priorities. As Ian said, this is an exciting time for BT. We're making a number of investments across the group, be it in our networks, things like fibre and mobile; our products, for example Ethernet or TV; and in our customer service.

My first priority is to make sure that we execute on these. The second priority is to keep investing in the long-term future of our business, while delivering on the financial promises in the short term. And if we do this, we will achieve my third priority, and that is growing cash flow sustainably over the long term.

And how are we going to do this?

Slide 20: Hopefully, this is a slide that is familiar to you. This is our strategy. I helped create it, and I'm committed to it, and it's not about to change.

Four years ago, we set out a strategy to make BT a better business with a better future. And under Ian's leadership, we've made very good progress towards that goal. But as Ian himself would say, there is still plenty of opportunity.

There is much we can do to improve customer service, for example. Not only does it mean happier and more loyal customers, but it underpins our cost transformation by removing the cost of failure. And as Tony said, there's a lot more we can do there as well.

This in turn, gives us the oxygen to invest in the business and invest in our future. And by focusing on our six strategic priorities shown here, we will make BT a better business.

Slide 21: So this is an exciting time to take over the helm. BT has strength in depth and it has a very strong team. This is true both across the group and in Retail, and I'll be announcing shortly the leadership succession plans there.

And as Ian likes to say, there's always more to do. Thank you.

Ian Livingston

Slide 22: Gavin, thank you very much. I'll pass back to Bhupendra to give instructions for questions we'd like to hear from you.

QUESTION AND ANSWER

Nick Lyall - UBS

Can I ask firstly on the line numbers and line losses? It seems like it's very strong numbers in terms of line losses, but broadband a bit less, so more in line with expectations. How big was the DTT Sky switch-off for subs? Is that big enough to make an impact?

And then secondly, I know it's very, very early days and you're probably going to knock me back, but 500,000 Sports subs, has that made any change at all in terms of churn numbers for broadband, please?

Ian Livingston

Yes, it's difficult to tell exactly the Sky thing but it did certainly have an impact. There was a few tens of thousands of people it affected and how many of them decided to switch off and not take, but it did have an impact.

In terms of line losses, yes, the number is strong. I think it continues a trend that we've seen, and that's something that we would like to push.

We actually thought the broadband was a good number. In the quarter, I have to say it was a pretty quiet first six weeks to the quarter. The second six weeks was a lot better, and interestingly, that's at the time we announced Sports.

And we are seeing positive impact on churn and, of course, a lot of TV, the Sports numbers we talk about, happened after the end of the quarter.

What we expected to happen in terms of Sport is what's happening, which is the first people who would be signing up would tend to be our existing customers. Not completely, but the majority of them would be, because actually the service isn't there so it's an easy sign-up for them. And then we would start to see the mix change somewhat into getting more new customers. And certainly, in the recent weeks we've seen that as we get nearer and nearer the start date for it.

So in terms of mix, that sort of change has happened, but we certainly were pleased with the overall number. And actually, we were pleased with the broadband number, because if you look quarter on quarter against Q1 last year, it's up quite a bit.

Q1 is a quiet quarter. Remember you've got a lot of students disconnecting, for instance. So I think we've got to look at it when you get to Q2/Q3 in terms of the overall impact.

Paul Sidney - Credit Suisse

Just a couple of quick questions, please. We're now seeing Sky pushing fibre much more aggressively over the past month in terms of offers and the adverts that we've all seen. I was just wondering, has Openreach seen a pickup in wholesale fibre connections over the last month as a result?

And just a very quick second question. What proportion of your BT Sport customers so far do you think are also Sky TV customers?

Ian Livingston

I'll ask Gavin maybe to talk in general terms about the second one in a second. Certainly there has been, we think, a substantial number of customers who effectively have signed up to 12-month contracts with us who are BT broadband customers and also Sky TV customers; and they are, of course, reasonably vulnerable customers. But I'll let Gavin talk more about that.

In terms of the wholesale side of things and wholesale fibre, it would be incorrect of me to comment about Sky per se. I did make a comment that we have seen a growing proportion of the fibre numbers, particularly over the last month, six weeks, actually coming from third parties, and that's encouraging and positive.

And we saw an improvement in Q1, for instance. It was, I think about a quarter, 26%, and that's an improvement. I think pretty much every quarter we're seeing that number tick up, and that's good.

So you'll have to ask Sky tomorrow as to the reaction they've seen to their advertising and fibre. But certainly, as you say, they do seem to have been advertising it significantly more over the last four to six weeks.

Gavin?

Gavin Patterson

Paul, I'm not going to give you the specific number, but it's the majority of customers that have signed up for the channel so far, are signing up to watch it over the satellite platform.

Wilton Fry - BofA Merrill Lynch

Your reported revenues were down 1.2% in the quarter. Just looking back at the history, that's actually the best result in 16 consecutive quarters. Obviously, fibre, Global Services, Retail all going well. I was just wondering, looks like the underlying picture is certainly starting to inflect. When can we start factoring in revenue growth for BT?

Ian Livingston

Whenever you feel fit (laughter). As we said, it was going to be about -- headlines are affected by things like FX, and I think we've been -- we very intentionally didn't make the statement it was the best for 16 quarters because what we try not to do is just pick a number that suits us in different things because the underlying position is really, you've got to look at it excluding FX because the pound may go in one direction or the other.

But we are seeing the various switches flicking up; Wholesale, and particularly when we get rid of ladder pricing in the comparators. We've seen it happening in BT Business, which is up. I think we've seen Enterprises, Ireland. And, of course, Consumer is doing better and it hasn't yet had the revenue benefit of Sport.

So as you start to flick these switches really from slight declines to slight increases, I think you'll start to see that coming through in the underlying top line number.

So we're doing what we said we would do in terms of this trend, and it was encouraging. It was above the external expectations and we were pleased with the revenue number and we're in the right direction. So I would hate to take away your job by predicting it for you.

Nick Delfas - Morgan Stanley

Just a question on the restructuring charges, because obviously, the adjusted figure is after £84 million of charges. Could you give a bit more information on what those charges consist of and how much of them are related to redundancy and how much to other costs?

Ian Livingston

Thank you. I'll ask Tony to talk in a bit more detail. I don't think we're going to give detail about -- we don't actually have redundancies in BT. Some of it will be related to people; some of it related to other things. But I'll let Tony talk about it.

But of course, they're in line with what we said would happen last quarter, so I don't think it's anything new news in these restructurings.

But, Tony, anything to add?

Tony Chanmugam

Yes, the costs come in three buckets. So it's basically people, network and property. The majority of the costs related to people costs.

Nick Delfas - Morgan Stanley

So if that's people costs but not redundancies, what are they exactly?

Ian Livingston

Well, some of it's as we retrain and redeploy people, put them through our transition centre. There is some people who take out some leaver packages. So it's different things in there.

But at the same time, of course, we recruit engineers and things like that elsewhere. So we've just put an advert out for 100 engineers in the Highlands recently to help with the fibre programme.

So there is some people who have left and some money paid to people to leave, but they're not redundancies, actually; they're people who have put their hand up for some leaver terms. But a lot of the things we do, we run people through a transition centre, retrain them, and some people that we redeploy them in other parts of the business, and it allows us, for instance, to take insourcing and things like that.

Nick Delfas - Morgan Stanley

And property is buildings which were vacated and the lease still has to be paid for a number of years?

Ian Livingston

Yes.

Carl Murdock-Smith - JPMorgan Cazenove

Two questions, please. Firstly, just on the improvement in Consumer and Business call and line decline, I was wondering roughly what proportion of call revenues are now contracted as those are variable. And also, what proportion of your Consumer customers take an unlimited call package?

And then secondly, could you just give a bit more color on the low cash tax and what read through that adds to the rest of the year? And also, to what extent did you know about this when you issued your guidance in May?

Ian Livingston

On tax, it's pretty much in line with our guidance. The reason why it's a low cash tax actually is because we've overpaid tax in previous years. We are particularly prudent with the way we pay our tax and it does mean we tend to end up, when you look to prior years, we tend to end up with repayments, and that's something that we have done. And that really reflects that and some settlements to [HMRC] reflects the situation. So it doesn't change the guidance that we've got on the overall cash flow.

In terms of proportion that relates to contracts and unlimited, I know Gavin was keen to answer that question.

Gavin Patterson

In the Consumer business, about 30% are on unlimited packages, but our strategy continues to be to try and increase that by providing more value for customers and ensuring that they benefit from giving us a contract commitment.

Ian Livingston

I think one of the things that you see in our numbers is just what the low percentage of our overall business is actually making voice calls. And that actually puts us in a very strong position, because we can treat voice in a very different way, I think, from other people.

And as Gavin said, for instance, the SmartTalk application, we just incorporate that within an all-you-can-eat package. And ultimately, the marginal cost of a call for a lot of our customers should be zero. And that, I think, is the direction and something we're trying to move people to.

Sam McHugh - Sanford Bernstein

We've seen some of your peers starting to introduce vectoring and things like that. Could you talk about the regulatory and technical challenges you think you might face before you can introduce vectoring?

And then a quick second question. On the regulation slide, you talked about the additional costs to be included in the charge control review. Do you think there's a possibility that the MPF rental fees actually end up increasing in the financial year 2015?

Ian Livingston

It's in the range of possibilities (on the second one) that it does, and we'll be pointing out why we think it should. I don't think the range will include a huge increase, but certainly, in the range could be a small increase. I would guess a small reduction, that would probably be in the range.

But probably I'll ask Liv to talk about that and also some of our plans for vectoring, because certainly, vectoring does present an exciting way of enhancing speed for a number of people in the UK, and it's something that is very important that from a regulatory point of view they assist in actually providing the best outcome for the UK population.

Liv Garfield

Thanks, Ian. So on MPF pricing, as you know, the most recent information we've seen is a [RPI minus] 0% to minus 6% range. As Tony says, there's a number of costs on line rental. RPI minus 0% to minus 6% on last-year basis.

As Tony said, with the missing costs we'd like to discuss over the course of the summer with Ofcom, and are doing so. I think the end outcome, as Ian said, is it will be one way or the other in a small range, and I guess it will take a long time for us all to know.

There are other ancillary costs which currently have some, I guess, downward pressure on them as well. So I think we'll have to look at the total impact at a revenue level of not just the rental for the ancillary costs to be able to understand the total impact on Openreach looking into next year.

On vectoring, one of my favourite topics, so delighted to have a question on it. We believe this is a really great technology. It's something we've been trialling in the labs for a good, decent period of time. We are now heading into live field trials.

We've actually placed orders going down the line that all new cabinets will have vectoring on them, so we're firmly committed to this. It's less I guess a lab technology and more a real life thing for us going forward. So what you will be looking forward to, if you've not been a fibre cabinet lucky person up 'til now is that when you do get your cabinet near you, you'll get a vectored cabinet, which means that we'll be able to secure even greater speeds in the future.

I think we're comfortable that although we will need to continue to talk about standards, we will need to make sure that we get the technology right. We're very comfortable that we've made numerous changes in our technology roadmap on fibre over the last couple of years, and we've managed those well. And I think we're comfortable that there is strong European support for vectoring, and we look to make sure that we follow that support models to make sure that we can get into a good place, and live.

And I think time windows and time-wise, we believe that we will looking into, as I said, go live with trials imminently in the field and much bigger scale next year. Obviously, the major I guess debate that continues, as we've seen by Deutsche Telekom, is what happens with the SLU line. I think we believe that what we've seen in Germany is a good model whereby if you do vector an area that you accept that you've got a compromised situation there with SLU. That's something that we're in discussion I guess in the UK about.

The guidance that we all received from Ofcom's recent documentation is that they are supportive of vectoring. They're also supportive of SLU. So I guess it's about working out how the two coincide, and we'll be looking to understand that. I think vectoring gives fantastic benefits in areas for customers, so I think there's a good argument that vectoring should be encouraged and supported.

Ian Livingston

Yes. To put it in context, vectoring can make 100Mbps plus a reality for people, and people just couldn't consider this could be achieved from fibre to the cabinet. It was just a couple of years ago people said we need fibre to the premise to get to three-figure megabits per second. And also, as take-up increases, it also will ensure the performance is good.

So it is very important that actual delivery of vectoring is in no way held back by people saying that one day they might do something with a cabinet, and I think from a UK national interest point of view, that's what I would imagine the regulator would want to see a way to achieve that.

Steve Malcolm - Arete Research

I'll go for a couple, please, first of all, both on BT Sport. I wondered if you could give us an idea as to what the retention activity was in the six/seven weeks you had launched the channel in Q1 against what you'd consider, I guess, normal retention activity. How many extra customers did you retain on a 12-month contract against what you might have done 12 months ago?

And then secondly, can you give us an idea of how many of those Sport customers signed up for fibre for the first time and how you might expect that relationship to develop as the channels go live in August?

Ian Livingston

Steve, it's one of these things. We actually had a debate do we give a number for anything at all for Sport. We just thought, actually, there's so much interest in it, we should at least give effectively what's a flash number before it's even started. We then said that we'll get lots of supplementary questions; at some point, we're going to have to say, actually, we're not going to sub-break it down. It's too early yet.

We are going to see a change in the mix of what people are doing when they take Sport. As Gavin said, the majority of the people who are taking Sport just now are actually taking it on the satellite platform. Now that's going to be great because they sign up to a long-term contract, and there is certainly some early signs of churn benefits coming through.

But, it's very early. We're at 11 weeks since we made the announcement and we're a week before we actually launch the service. I think when we talk in November we'll give some more insightful analysis. We can decide what that will be but we can give some more analysis, because actually, we'll have some more, longer numbers then.

But suffice to say, Steve, you'll be able to watch the SPL Champions, which I know you'll be very pleased to do, very shortly.

Steve Malcolm - Arete Research

A quick follow-up. When we look at the next couple of quarters, if things go as you hope they will, how should we think about the good metrics to follow it? Will it drive fibre first followed by DSL and then TV takes a bit longer because of that Sky effect? What's good KPI success if it goes to where you want it to?

Ian Livingston

We said always the overall thing to look at is top and bottom line growth in our Consumer business. That's really what we were looking at. I think broadband is at the core of it. I wouldn't like to then start saying, well, look at this fibre and that, because for instance, a fair chunk of the population, although a minority nowadays, are not in fibred areas, and that's becoming a less minority. But I think looking at what's happening on broadband is very important, and of course, the total overall take up.

But I think that's a start. And overall, do we make more money at bottom line? Does our revenue grow in the Consumer and Retail business? And that becomes the critical overall metric and the sign of success in the whole strategy.

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Simon Weeden - Citigroup

I've got a couple. First is are you now done and closed in terms of wholesale arrangements for BT Sport with TalkTalk, Virgin and possibly even a different relationship with Sky?

And then secondly, I suppose it's a bit harder to answer, but you mentioned that if the cost base used for the Ofcom LLU price ruling is advanced to 2012/13, that will be favourable to you. In other words, it sounds like you expect the cost to be rising in that period. Given the hiring and the various other things you've got going on in Openreach, is that not the case going forward?

And if so, is there a very big gap between what you think your costs are doing and what Ofcom thinks your prices should be doing given what we see in their announcement?

Ian Livingston

Well, I think their announcement did highlight that there were some things they had to consider, and I would hope that they would recognise everything that we point out to them and incorporate it within the number. I suspect life doesn't quite work exactly like that.

But actually, it's pretty straightforward and factual what we'll be presenting to them, and they recognise that there is a gap. I wouldn't call it a big gap, but there's certainly a material gap in terms of overall impact. And the fault rates are clear. The higher quality of service costs are clear. These things are pretty clear.

In terms of wholesale Sport, no, the door is not shut on that issue. There continues to be discussions, not with Sky I don't think, but there is continuing discussions elsewhere in the industry and we'll have to see.

We know what it's worth to us to wholesale it, and I think the important thing to say is there's no dispute in principle with the other parties in that sense. It's merely whether we can reach a price that makes sense.

I'll say what I said last quarter, one of three things will happen. We either won't do a deal; we'll do a deal now; or thirdly, when they see just how good the proposition is, we'll do a deal later on in the season.

But it's a good sensible discussion and we'll see if the gap can be narrowed and we have a wholesale deal or we might not. But discussions are ongoing.

Stephen Howard - HSBC Global Research

I just wanted to ask you about some indications that not everybody in government seems to be as happy as they might be with BT’s superfast broadband deployment and the current state of competitiveness in this particular market.

There was a rather interesting meeting of the Public Accounts Committee last week. One of the MPs referred to some of your accounting relating to the BDUK program as outrageous and labelled your assessment of the costs as crazy.

Some of the MPs also, rather incredibly to my eyes, seem to think that BT is a monopolist in the superfast broadband market.

So what I wanted to ask is are you worried that some of your retail competitors are winning the PR war here? And, Ian, is there anything that you can do to set the record straight once you head into government?

Ian Livingston

In answer to the last question, absolutely not when I head into government. My remit does not cover anything to do with BT other than BT being one of the country's significant exporters and investors, and no different from any of the other companies in the UK.

What I can say as Head of BT, which I am and will be for a number of months, is that first of all, the PAC is not government. You said that government are unhappy. Actually, nobody in the PAC is in government. As you said, there was a number of somewhat bizarre statements being made there.

And if you've watched PAC committee meetings, they are clearly designed to attract publicity rather than to getting to the underlying truth. And the underlying truth of the situation is we would have loved there to be somebody else bidding for these contracts. The fact that we are the only people prepared to spend our money for double-digit year returns I think is a criticism of them, and you had one witness there saying the BDUK intervention area was too big, one saying it was too small, and one saying it didn't make any difference but she thinks it's a margin squeeze. So they're all saying somewhat different things.

There's huge amount of available information we provide. We've got a situation where, for instance, in Cornwall where we said we'd provide 85% of fibre, we've now revised that to 95% because, actually, our costs have come in a bit less than expected. So actually, the benefit all goes to the government.

And the overall situation, one has to look at the overall situation, the UK is going to end up with well over 90% of the UK having fibre. It's going to do it for a government intervention that would make Australians cry if you look at their size of government intervention.

In fact, you look across Europe at the scale of intervention versus the scale actually of delivery and we are seen around many parts of the world as a real model of success.

It is just a shame that there's a number of people in the UK who actually don't want to talk up the UK, and the UK has really been highly successful in this area.

I know Gavin feels very strongly on the same thing. What BT will do is continue actually to talk up the UK and to point out we have some of the cheapest available fibre in the western world. It's available to anyone to sell, and as you see, more and more people are selling it. It's amazing, if you advertise it, you do tend to sell it a bit more. And it's going to many, many rural areas and it's a big success story for the UK.

So when I, and when Liv, talks to the government, most government officials recognise it's been a great success, and government asked us to go as quickly as possible, and that's what we've been trying to do.

James Ratzer - New Street Research

Two questions, please. The first one's regarding your broadband market share. I think you've got about a 31% broadband market share nationwide. Are you able to give us guidance on what your market share is in the areas where you've rolled out the 16 million fibre premises?

And the second question was regarding your UK consumer broadband & TV revenues, which I notice this quarter have fallen sequentially for the first time in two years. And you also mentioned in your release that the 500,000 Sport customers are mostly existing customers re-contracting their broadband. Are those two points linked, are new customers signing up on slightly cheaper broadband deals?

Ian Livingston

Well, I think consumer broadband & TV's up 9% year on year. So I really wouldn't get too concerned, you do get quarterly sequential number, number of weeks in the quarter, how exactly various costs are done. So I wouldn't really be too concerned about that.

In terms of fibre, I won't really talk about the installed base, but certainly, we do see much better adds in areas where we've got fibre for BT Retail. We've definitely done a lot better in broadband in the areas we've got fibre.

I don't know, Gavin, do you want to add anything more on that?

Gavin Patterson

I was just going to say the ARPU gets affected by the timing of Easter every year, so that's one thing to bear in mind.

As Ian says, there's nothing of particular concern in the way the ARPU is growing across the Consumer business. We'd expect that trend to continue going forwards.

And while we don't give out the numbers, I think typically we're growing 3 times as fast in areas we've got fibre rolled out as we are in areas that we haven't. So that's another positive trend.

James Ratzer - New Street Research

Are you seeing anything on a positive side with customers re-contracting? Are they now signing up for some of the higher end packages when they're calling in to your call centres?

Gavin Patterson

When we're upgrading people to fibre, we find that we use that as an opportunity to sell to people on the benefits of the top tier. So we do improve ARPU at point of sale quite significantly. It's not a number we've given, but it is part of the strategy and you do see that coming through in the numbers.

John Karidis - Oriel Securities

Two questions, please. Firstly, can you talk about the phasing of the marketing costs within BT Retail during the year and, indeed, relative to the first quarter?

And then secondly, I'm always struck by the contrast between yourselves talking about retail pricing not being inflationary and the likes of Sky and TalkTalk on the other side, however, saying that it is inflationary and it's actually BT that's allowing them to increase prices. So I wonder if there's anything that you can comment on, on this issue, please.

Ian Livingston

Well, I don't think we've talked really about inflationary or not inflationary, but I will say you have seen in line and occasional call prices, you have seen, probably, inflation-type rises. But actually, in other areas such as broadband, you've seen customers getting a lot more for the same price. So the actual value to the customer has been significantly higher.

Our ARPU has gone up, but the reason our ARPU's gone up is people are trading up to higher specifications or adding more to their packages. So we've seen a 5% increase roughly in ARPU year on year, so that's strong in that way. But customers are getting a lot more for their money.

And the UK has seen a substantial reduction in real prices over the last 20 years in telecoms and, as I said earlier, it is one of the cheapest markets in the western world.

So I think people are getting 'more for the same' is, as I would probably express it overall, and that's the situation. Obviously, if TalkTalk and Sky want to talk about increasing their prices, I hope they'll be telling customers much the same.

John Karidis - Oriel Securities

In terms of marketing?

Ian Livingston

Well, we've given the overall numbers in terms of the overall cost of Sport, £40 million this quarter and about £100 million next quarter. The next quarter we start to amortise the programming costs in there as well. Obviously, marketing is weighted towards the first half of this year, but I think beyond that, we're not going to give any further split on it.

John Karidis - Oriel Securities

Thanks. Ian, good luck.

Ian Livingston

Thank you very much.

Guy Peddy - Macquarie Research

Just a couple of quick things. I picked up on your commentary, Ian, you talked about fault lines or faults on lines increasing, A, because of weather; but, B, because of capacity demands. Can you just talk a little bit through that? Because I thought Infinity and fibre, etc., should reduce the number of faults.

And, secondly, probably a question for Gavin. Given it's going to be difficult to interpret the success of BT Sport on Infinity in the short term, should we, therefore, watch BT Vision customer numbers over the next two to three quarters as a read for how many incremental customers you're actually adding to the BT platform from BT Sport?

Ian Livingston

Well, no, we actually answered that question already. We said actually probably you had to take, outside the old traditional sort of things of top and bottom line growth over the long-term; we said the the two things to look at was sign-ups and broadband, and that's what we said was probably [the right measures], we felt, because people might well sign up to Sport but actually run it on, for instance, satellite.

So, that wouldn't affect our TV adds but either they pay for it or they'll take broadband from us. So, it's actually broadband not the TV adds which is the critical thing. So overall Sport sign-ups and I think broadband numbers would be ones to look for.

In terms of faults, it's not about capacity, it's about if you start running more and more speeds over a particular network, it just shows up faults more. And particularly people are using it more and more, and [there are] more and more, shall we say, demands [made] of it, so sometimes small issues in the network, things that in the past when they were just looking at their emails and it was running a bit slower, occasionally there's a problem, they wouldn't be too bothered. But now, when they're running many more services over it, they would call out for a fault.

Fibre to the cabinet does not inherently have less faults. Actually, your increasing your broadband speed overall tends to increase the faults for the reason I said before.

So it's a combination. We are going to have -- the weather patterns in the UK are getting more extreme, and that's certainly having an effect. The use of the network and what people expect from it are also having an effect. And, of course, it’s also got to be said the working system sizes, i.e., the number of people not just with lines but also taking broadband over the network is going up as well. So fault rates are going up because of what the network's being used for.

Andrew Lee - Goldman Sachs & Co.

Ian, I know you'd hate for your last call not to feature a question on mobile, so I just wanted to just ask, we are starting to see M&A in Europe now as companies prepare for convergence. Would you rule out the need for M&A as part of your mobile strategy, or can you execute a convergence strategy with just an MVNO contract and the benefits of a wi-fi offload?

And I wonder if you can just give us any detail on how great your opportunity is to offload mobile capacity through wi-fi?

And then just a quick second question. Given the majority of sign-ups to BT Sport is satellite TV, does that indicate a more targeted approach to sign up those types of customers by you, or is it just much greater demand from that type of customer?

Ian Livingston

I think on the second one, it actually reflects the people who are signing up, just at the beginning, before the service is started, you tend to get some of the people who actually don't have to change anything. In the case of satellite TV or if they've already got BT TV services, it's a very, very easy upgrade for them.

They don't have to do anything much, which makes sense, and that's what we thought would happen before the service started. So I think it just reflects customer response, actually, not particularly our targeting.

In the case of mobility, your question failed to mention the fact we bought rather a lot of 4G spectrum. I think we did very well in the spectrum auctions, and that 4G we think will allow us to develop, and this is something we talked about on the strategy day, very much an indoor-out strategy.

So it isn't just wi-fi, it's that 4G spectrum. But if you want to talk about wi-fi, the billions of minutes, the 4 billion roughly minutes of use in Wi-fi in the quarter, I think that highlights your degree of offload and the fact that tablets, and I'm sure yours does it, first of all it looks for wi-fi, and only then does it go to 4G.

But we'll combine that with our 4G spectrum, and we've got a low, not all-spectrum vehicle, clearly; we've got about, I think, 10% or 11% of all-spectrum now in the UK, and what we'll do is develop that combined with the fact we've got a lot of broadband lines into customers' homes and businesses, which effectively creates a very low cost backhaul, or we can put together a very strong indoor network offering that will be really data-focused, and when people are out and about they can roam on our MVNO.

So I think there's a great opportunity for us actually organically in mobile and I refer you to our strategy presentation where we went through some of the opportunities, and that certainly remains the case.

Jerry Dellis - Jefferies

I've got two questions, please, firstly, on TV, YouView. It seems to have been less of a focus so far. I wondered whether that is deliberate and whether perhaps the launch of multicast channels next week is the precursor maybe to stronger TV net adds.

And then, secondly, in terms of Retail, if I eliminate from your headline EBITDA numbers the TV cost that you incurred in the quarter, it would appear as though underlying EBITDA growth at the Retail level grew around about 8.5% year on year and the trend has been 3% to 5% over previous quarters.

And even if we look at the opex trend ex-TV to eliminate the pricing effect, it still looks as though the opex base at Retail is falling anywhere between 4% and 6% year on year over most of the recent quarters.

So I just wondered really what is going on within the Retail base that is enabling such a strong cost reduction and to what extent that's sustainable over the next 12 months or so.

Ian Livingston

Well, I think I've got to say the performance of Retail reflects outstanding management, which I'm sure we can bring to the Group as a whole! But Retail's been reducing its cost base for -- by that mid single-digits to slightly more for now seven and a bit years. And you're quite right to say if we hadn't done TV you would have continued to see that. And one of the things we haven't sought to do is say our profits, excluding investments, are really this.

We knew you'd be interested in the investment number, but I know some other people try and exclude the money they're spending on investments, but we actually think our job is to pay for it with the cost transformation programme.

What you've seen in Retail I think good numbers in BT business, strong profit growth there; top line growing. Of course, the Consumer top line is only 1% decline, which is a lot better; and Enterprise and Ireland.

So the answer is all the bits of Retail are doing well, and effectively, that's paying for the last quarter, the investment we're making. But Retail continues to show cost transformation, and also the investments we've made in the past, what they can drive in terms of improvement.

In terms of YouView, you're right, multicast is coming, and that's over YouView, and I think will make a particularly attractive package. I think our focus on YouView is slightly different from some other people, and I may ask Gavin to say more on this, but we're focused, I think, on a package that actually increases our ARPU that people are spending money getting services because we know, and we incurred this in the early days of BT Vision, you want customers who are committed to some of the subscription, because if they're not, you find that they have pretty poor churn characteristics.

And so I think we've learned that lesson in time past and we're focused on a slightly different customer base than some other people [prevailing] in YouView.

But, Gavin, do you want to add anything to that?

Gavin Patterson

I think the only other thing I would add is that in Q1, our focus was very much on Sport rather than TV per se. You need to get some focus, you need to get some critical mass behind your marketing efforts rather than necessarily splitting it between a number of different messages. And that's what you see to some extent in the numbers.

To Ian's point, I think as we go into this quarter with multicasting coming online, I think you've got a very strong proposition for customers. We know that channels in conjunction with on-demand content at a very keen price is something that customers want, and we can see that in the early results we've got, both in terms of the early sales and the customer satisfaction around it. So I think you'll see that change going forward.

Ian Livingston

Yes. And the multicasting is very, very good. The HD channels are actually better than broadcast, so it's actually an excellent proposition.

Which leads , I think, to the final question. James, I think that falls to you.

James Britton - Nomura

Ian, the final question for you as CEO. No pressure. I was actually going to ask perhaps Tony, but I'm sure Ian will have a better perspective. But what wage terms have you been able to agree with the unions for this year and next? And are you planning any more discounted share-based programmes for employees to increase that share participation in the workforce?

And then perhaps one on Openreach, actually no, I'll move to fibre. So a general question; this seems to be the first quarter in which retail fibre adds went up a step higher than the previous quarter. Can you just explain why that fibre demand has stalled a bit this quarter?

Ian Livingston

On the retail front, despite the fact you've asked everyone else apart from me, I'm going to answer for both of them, on the fibre demand, year on year it's up, of course, considerably.

Q1 is a quieter quarter, as I said, actually. Things were a bit quiet at the beginning of the quarter. And there's nothing particularly that concerns us in the retail fibre number, but there's a bit of seasonality in there. So that's okay.

In terms of relationship with our employees, if I understand the question, we've got a big save-as-you-earn scheme which about 20,000 employees signed up to, coming due. We've actually got a smaller one that comes due shortly, but in a year's time, and it allows a large number of our engineers, call centre people, etc., to share in the significant benefits of the investment they made five years ago.

We run the save-as-you-earn pretty much every year, and the share issues that go with it is why we've had, of course, the share buyback on the other side.

We've agreed with the unions the deal for this year, which was very strongly approved by the workforce, and we think it's right that our people have benefited from the success of BT. I think it's a very good model. And we'll be really pleased when both this year's save-as-you-earn scheme and next year's save-as-you-earn scheme matures and our people will be able to see the benefits of the success of the company.

So that continues to be our approach. We'll try and work constructively with our unions. Of course, as a business, we've got to be more and more flexible. But also, we recognise we want our people to be rewarded back from the success of BT.

So I think there's nothing else. I'm looking around. Was there anything else to add from my colleagues?

So thank you very much. And again, thank you to all of you. No doubt I'll see you in different guises in the future. And I'm sure Gavin and the team look forward to speaking to you in November.

Thank you very much.