Operator

Ladies and gentlemen, thank you for standing by, and welcome to AT&T's Second Quarter 2012 Earnings Release. For the conference, all the participants are in a listen-only mode. There will be an opportunity for your questions, and instructions will be given at that time. (Operator instructions) As a reminder, today's call is being recorded.

With that being said, I'll turn the conference over to Susan Johnson. Please go ahead.

Susan Johnson

Thank you, John. Good morning, everyone, and welcome to our second quarter conference call. It's great to have you with us this morning. I'm Susan Johnson, Head of Investor Relations for AT&T. Joining me on the call today is John Stephens, AT&T's Chief Financial Officer. John will provide an update with perspective on the quarter, then we'll take your questions.

Let me remind you, our earnings material is available on the Investor Relations page of the AT&T website, at www.att.com/investor.relations. Okay, I also need to cover our Safe Harbor statement, which is on Slide 2. This presentation and comments may contain forward-looking statements. They're subject to risks. Results may differ materially. Details are on our SEC filings, and on AT&T's website.

Before I turn the call over to John, let me quickly cover our consolidated financial summary, which is on Slide 3. As a reminder, we completed the sale of AT&T's Advertising Solutions, and AT&T Interactive business on May 8. Our reported results for this quarter and prior period still include Ad Solutions' results, which are not treated as discontinued operations, given our 47% continuing equity ownership in YP Holdings.

Reported EPS for the quarter was $0.66, a 10% increase both sequentially and year-over-year. The fundamental trends in our business continue to be solid. When you exclude the Advertising Solutions business, consolidated revenues were up 2% year-over-year. Thanks to strong mobile data growth, gains in U-verse, and advanced wireline business offering.

We had our best consolidated margin in four years, with operating income expansion in wireless and wireline, both sequentially and year-over-year, and cash flow continues to be strong. Cash from operating activities for the quarter totaled $9.7 billion. Free cash flow was $5.1 billion. And our share repurchase program continued in the second quarter. In the quarter, we bought back almost 76 million shares for $2.5 billion.

With that quick overview, I'll now turn the call over to AT&T's Chief Financial Officer, John Stephens. John?

John J. Stephens

Thank you, Susan, and good morning, everyone. It's great to have you with us on this call. As you've seen, we had a very good quarter, and it was very straight forward, all about executing our strategy and growing the business. In wireless, you can clearly see the benefits of our mobile Internet strategy. This has resulted in strong wireless data revenue growth, almost 19%, record high service margins with our EBITDA service margins hitting 45%, and our lowest churn ever, postpaid, prepaid in total.

In wireline, the transformation from legacy voice and data products to advanced data services continues at a solid pace. U-verse video and broadband continue to scale, while driving the strongest consumer revenue growth that we've seen in years. And we kept margins steady and improved wireline operating income, both sequentially and year-over-year even with few signs of a business recovery. This performance drove solid financial results. We grew revenue, expanded margins and increased earnings, and cash flow was very strong.

We also took steps to make our balance sheet even stronger, recall debt and reduce future interest cost by refinancing at favorable rates. And as Susan mentioned, we continued our share buyback program, we've returned more than $5 billion to shareholders through share repurchases and dividends in the second quarter, and close to $10 billion year-to-date. All in all, a very positive quarter, which puts us in a great position heading into the second half of the year.

With that as background, let's now take a look at detailed results starting with the consolidated revenues on Slide 5. As you know, the sale of our Advertising Solutions business was completed in early May, so this second quarter did not have a full impact of Ad Solutions revenues. And because we retained an equity interest in the business, we cannot restate past quarters. Even so, on a reported basis, consolidated revenues increased year-over-year, and if you exclude Ad Solutions from all periods, they were up $600 million or 2%.

The drivers are: Strong mobile Internet growth, U-verse revenue growth of more than 38% and continued growth in strategic business services. When excluding Ad Solutions, 80% of our revenue came from wireless, wireline data, and managed services in the second quarter. That's up from 77% a year ago, and 74% two years ago.

Revenues from these growth areas, these next-generation products and services were up about $1.3 billion or more than 5% in the quarter. We've made remarkable progress in transforming our business in the last few years, and we expect this mix shift to continue.

Now let's look at Wireless, starting on Slide 6. We have confidence in our mobile Internet strategy, our network and the ability of our team to execute and compete. After our second quarter performance, that confidence has only been reinforced. Margins were at record levels.

As you've seen, our service EBITDA margin for the quarter was 45%, and churn was at record lows, revenue growth was solid, thanks to gains in data revenues. This drove our 14th consecutive quarter of postpaid ARPU growth, and phone-only ARPU was up more than 2% growing off a much higher ARPU base than anyone else.

We now have more than 43 million smartphone subscribers on our network, or about 62% of our postpaid base, and smartphone sales continue to be strong. We also continue to bring more subscribers on to our network with usage-based data plans. It's been two years since we introduced these tiered plans, and we now have 27 million or about two-thirds of all smartphone subscribers on these plans, with most choosing the higher price plans.

Let's talk more about churn and net adds; details are on Slide 7. Postpaid churn hit an all-time low, dropping below 1% for the first time ever. We also had our best ever total in prepaid churn. There are a number of reasons for this, the quality and depth of our network, and improved customer experience, our focus on customer-friendly plans, and the fact that we have 88% of our subscribers on FamilyTalk or business plans. For all these reasons, customers are choosing to stay with AT&T.

We also continue to add new customers, 1.3 million in the quarter that includes gains in every customer category. Postpaid net adds were 320,000, an increase from the first quarter; prepaid added 92,000 subscribers. A solid reseller quarter netted us 472,000 new subscribers, and we have 382,000 connected device net adds as well. These results are tied directly to the performance of our network, and the quality of the customer experience.

We now cover 275 million POPs with our 4G network, with more than a third of our postpaid smartphone subscribers using a 4G device, and almost 90% of our data traffic is on enhanced backhaul. This drives higher speeds for our customers and greater efficiency in our network.

Our 4G LTE build continues on track, and we now have LTE in 47 markets. Record low churn and strong sales tell the story of our wireless business.

New customers are choosing AT&T and existing ones continue to stay with us in record numbers.

You can also see the strong performance in our wireless data results and in our smartphone and branded computing sales, which are on Slide 8. Data revenues were $6.4 billion, up $1 billion year-over-year. Data revenues are now at $25 billion annualized revenue stream, growing at almost 19%.

Smartphone sales were solid, and we continue to build our subscriber base with 5.1 million smartphones sold in the quarter. Smartphone subscribers now number 43 million, and make up 62% of our total postpaid base. But smartphones accounted for 77% of postpaid sales during the quarter, showing continuing opportunity for growth. And when you look at our total smartphone base, we've added 9 million high-value smartphone customers in just the last 12 months.

We also continue to activate more iPhones than any other carrier. We had 3.7 million this quarter with about 22% of those subscribers new to AT&T. These customers are choosing AT&T for a reason, we provide the best mobile Internet experience on the nation’s largest 4G network.

Branded computing sales also drive data growth. Sales continue to be strong in the second quarter. We had 496,000 net adds in the quarter, we now have 6.3 million branded computing subscribers, tablets and tethering plans on the network. And that's up more than 50% in the past year.

Last week, we announced our new shared data plans. We believe this will drive even more branded computing subscribers onto our network. But perhaps the best story this quarter is our wireless margins, details are on slide 9.

We’ve done a lot of work to improve our service margin and network is paying off. We’ve had our best wireless EBITDA service margin ever, 45%, but to put that in context, two years ago our margins were about 200 basis points lower, and this quarter we sold 1.2 million more smartphones than we did that. That helps show the value of our smartphone base, who’s ARPU was twice that of non-smartphone devices, plus smartphone subscribers have lower churn and strong data growth.

We’ve also taken several other steps that have a positive impact on margins. This includes our new upgrade policy, it’s been more than a year since we implemented the changes and we’re now seeing the impact. Our new data pricing plans we announced earlier this year also help drive revenues while offering customers more data, and our continued focus on overall cost management.

All this helps explain the strong growth we saw this quarter with our operating income, almost 18% year-over-year and 13% sequentially. We are pleased with our wireless results this quarter. Our entire team had another outstanding wireless performance.

Now, let's move to wireline, starting with business, which you can see on slide 10. Business wireline revenue was down 1.5% this quarter that compares favorably to a decline of 4.1% in the year ago second quarter. This business continues to be a multi-fast in its story that's playing out in a cautious economic environment. Customers that can't continue to invest are doing so, but others are holding off positions because they are more hesitant to spend in uncertain economic times and small business formations continue to lag even below last year's numbers, you can see this in our results.

Large businesses or enterprise customers continue to invest in advanced data services. This has led to improving revenues even without any lift from the economy. In fact, we're in our first enterprise revenue growth in more than four years. The growth was small, but still a positive trend.

At the other end of the spectrum, our small business revenue growth was down slightly sequentially once again challenged by the lack of new business starts. And our wholesale and government sector saw revenue pressure as some customers reduced legacy data connections.

We continue to see strong growth in strategic business services, that's products such as Ethernet, VPNs, and application services, which were up 13.5% for the quarter. This would have been even higher without the impact of foreign exchange. And IP data revenues were up more than 5% year-over-year as well. This shows the businesses continue to invest in efficiency and in advanced data services even in this tough economic climate.

We also held business wireline margins steady by doing a good job of keeping expenses in check. A positive growth in enterprise revenues is an encouraging sign, but we are facing continuing economic headwinds. There is a great opportunity in this business, especially as we continue to transition to advanced data services. But based on the current business environment, the return to growth in revenues, they take longer than we originally anticipated.

You should also see the transformation to IT data in our consumer results, details on slide 11. We had another strong quarter with our U-verse services. So strong in fact, that we are seeing our best growth in consumer wireline revenues in more than four years, 1.7%. U-verse has transformed wireline consumer. We now have 6.8 million total U-verse subscribers at both video and high speed Internet. That includes 4.1 million video subscribers with a 155,000 added in the second quarter.

And we added more than a half a million U-verse broadband subs in the quarter as well. This includes new high speed broadband small business subscribers. And U-verse revenue growth has been amazing. It's now a $9 billion annualized revenue stream, growing at about 38% year-over-year and we believe there is a lot of room for further growth. Overall video penetration is at 17% and continues to grow.

Now let us look at margins on slide 12. For the second quarter, consolidated margins were up both sequentially and year-over-year on track with the expectations we set out in January. Our consolidated operating margin was 21.6%, that's up thanks to strong performance in wireless and consumer wireline revenues, our continued focus on improving the customer experience, that's everything from giving the customers more choices, more ways to interact with us and doing a business in a way that customer prefers.

Wireline operating income margins also expanded both sequentially and year-over-year at 13.8%, that's in line with our guidance of stable wireline margins for the year. Helping offset declines in legacy services were growth in U-verse and advanced data, solid cost management and execution of one AT&T initiatives. We continue to keep a sharp eye on cost efficiencies and see more opportunity as we move ahead.

Along with solid margins, we continue to have strong cash flows and we have taken several steps to improve our capital structure. Our summary is on slide 13. In the first half of the year, cash from operations totaled $17.5 billion. Capital expenditures were $8.9 billion with more than half of that invested in the wireless business.

Free cash flow before dividends was $8.6 billion and dividend payments totaled $5.2 billion. In terms of uses of cash, total debt is down $1.2 billion in the quarter with a debt-to-capital ratio of 38.4% and a net-debt-to-EBITDA ratio of 1.42%.

We have been very active in the debt market taking advantage of favorable interest rates and our strong cash flows. We have paid off some debt early. We have called $7 billion in debt so far this year. We now have no debt due for the remainder of this year and only $3.5 billion due in 2013. At the same time, we continue to pursue share buybacks. In the second quarter, we repurchased almost 76 million shares. So far, we have bought back more than 143 million shares or about half of our 300 million share authorization. That totaled $4.6 billion of stock.

When you look at both dividends and the stock buyback, we returned nearly $10 billion to our shareholders in the last six months. And as always, any shares we purchase could include open market purchases, structured programs such as accelerated share repurchase and other programs including 10b5-1 plans where appropriate.

The quarter's performance demonstrates the strength of our capital structure. Our strong cash flow gives us the flexibility to both invest and retire debt. our balance sheet is sound, our debt metric is solid, and we continue to return value to shareholders.

Now, before we get to your questions, let me recap the quarter on slide 14. Our key growth drivers, wireless, data and managed services, now account for 80% of our revenue growing at a more than 5% rate year-over-year. Our mobile Internet strategy continue to click with strong smartphone sales, record low postpaid churn and the best service margins we have ever seen.

U-verse continues to power wireline consumer transforming the business with solid growth and record revenues. We also saw positive enterprise revenue growth even with no lift from the economy and we continue to strengthen our balance sheet while returning substantial value to our shareholders through dividends and share buybacks.

The transformation of our business took a major step in the quarter with the sale of our Advertising Solutions business and we continue to add to our wireless portfolio through spectrum acquisitions. Put it all together, we had a very strong quarter with continued confidence as we move into the second half of the year.

Susan, that concludes our prepared remarks, I think we are ready for Q&A.

Susan Johnson

Thank you, John. John, I think we are ready to open it up for questions and answers.

Question-and-Answer Session

Operator

(Operator Instructions) And first, we'll go to line of John Hodulik with UBS. Please go ahead.

John C. Hodulik – UBS Investment Bank

Great, thanks. Two quick ones. First, John, just on your comments on the business market, you turned positive on the enterprise side, do you expect that to remain positive going forward and as the slight changes, some incremental weakness on the sort of low end SME side? And then on the buyback, I'd say you guys have made a lot of progress there, do you expect to be substantially complete with the buyback by year-end? Thanks.

John J. Stephens

Morning, John. Thanks for joining the call. Let me take the second question first. With regard to the buyback, two things, we do expect to continue in the marketplace participating in buyback. That will be impacted by market conditions, continued strong cash flows, and the other factors that we spelled out. We have not guided towards when or how much we'll buyback in any of the future quarters. But I think, as we said at the beginning of the year and on the January call, we are in a position with the cash on the balance sheet with the beginning of the year, and strong cash flows this year that we have an ability to buyback a large part of the [authorized] share repurchase, and we'll continue to monitor that and continue to pursue those opportunities.

On the business side, we do have continued growth in strategic services, and that growth is encouraging to us, but we are seeing business has to be very careful, seems like whether they are hesitant about the elections, about tax law changes, about the federal deficit, they have abilities to spent or encouraged by that, but they are being very careful, we are seeing a lot of no decisions. So we're certainly hopeful to be able to continue our positive enterprise revenue story, but we'll have to prove that as well everybody else. We're still optimistic about our wireline business and believe particularly our business revenues are going to be positive going forward. It just may take as a little bit longer than we would have expressed to you in January.

John C. Hodulik – UBS Investment Bank

Gotcha. Thanks.

Operator

Our next question from Simon Flannery with Morgan Stanley. Please go ahead.

Simon Flannery – Morgan Stanley

Thank you very much. Good morning. John, I wonder if you could update us on the status of the review of the rural lines, and also churn investment this quarter, you went through some of the factors driving that. How should we think about churn going forward from here, you had a pretty substantial drop – is there more room for year-over-year improvements in that or if this is as good as you think you can get to? Thanks.

John J. Stephens

Morning, Simon. Thank you. First, on question with regard to kind of our strategic initiatives, you've seen in the directory sale and the completion of that, we've seen the continued movement on spectrum in 12 acquisitions of smaller acquisitions, why should we close a number of deals that are sitting before the SEC. And I think you've seen on – from the strategy side, our filing was serious where we're jointly going there to clear up some and improve some usability for some of the WCS spectrum we owned. So, those are parts of the strategy.

We're continuing our review on the other pieces of our business. And as soon as we have something for sharing, we will, but we are going through that process and we will continue to go through that process. Just want to be careful to make sure we complete that analysis and have a full story for you when we're ready to share it, Simon.

Simon Flannery – Morgan Stanley

Okay, because there was some talk of (inaudible) and so forth, but that's still an option rather than a choice at this stage, is that right?

John J. Stephens

Everything quite frankly at this stage is an option and we are looking at our whole host of different opportunities or different alternatives as you might expect, our shareholders would expect from us.

Simon Flannery – Morgan Stanley

Okay. On the churn?

John J. Stephens

On the churn side, it was very encouraging. It was not only encouraging on the postpaid, but it was encouraging that it was across the board, we saw improved churn. We are optimistic about our ability to hold onto those kinds of levels and continue to improve it. We will see as we go through some of the seasonality in the business in the second half of the year, how that impacted.

But this is a process that's been going on for a long time making significant investments over a number of years and improving the quality of our network. And our wireless team, including our business wireless team has put a lot of effort to improving the customer experience. So, yes, our networks getting better but the customer experience is getting a whole lot better, and so we are optimistic that we will be able to move forward building from this positive base.

But as we go on to the second half of the year and a part of the wireless business here that is much more seasonal, we'll have to work through that and see if we can meet our goals.

Simon Flannery – Morgan Stanley

Thank you.

Operator

Our next question is from Phil Cusick with JPMorgan. Please go ahead.

Phil Cusick – JPMorgan Securities LLC

Hi, guys, can you hear me?

John J. Stephens

Sure, can.

Phil Cusick – JPMorgan Securities LLC

Great, thank John. So let's just talk about ARPU for a second. Can you tell us if you guys expect any change in trajectory given the new price environment in the third or fourth quarters? And then also do you anticipate change in the reporting methodology over time as tablets dilute revenue per device? Thanks.

John J. Stephens

Thanks Phil. First and foremost, we think our guidance's out there, that we get 2% ARPU growth this year. We're sticking with that. We're encouraged by – where we are at on the 1.7% so far this year including all the impacts of high margin, high profit, but lower ARPU data in ten devices and tablets. As we mentioned in the call, our phone-only ARPU was 2% this quarter.

Why we're optimistic is because of the pricing changes we've done with regard to our tier data plans. We're also encouraged because of what we've done with regard to drawing the smartphone base by 9 million subscribers, converting those lower ARPU subscribers that we had last year to smartphones, and generally more ARPU. So we're encouraged by that. And we're also encouraged by the fact that there is a lot more usage going on in that structure of tier data customers. We get better additional revenue, people pay for what they use. So we're sticking with that.

With regard to any shared data plans, we need not expect those to be – we expect those to be accretive over time. We think the conversion of those is going to be measured over time, part of that is because we're doing like customer friendly, we believe in the old plans available to our customers and we are not forcing anyone off unlimited or any other plans. So we're expecting it to transition in, but over time we expect it to be accretive because it will allow, if you will our customers the more they share, the more they are going to save. And I think that will be good for both us and them.

With regard to our reporting activities, right now we're going to stick with our customer based ARPU. We'll continue to evaluate all of our customer matrix, and all of our financial reporting and we'll update that starting with next year as we always do. We are having a robust discussion about what's the best way to provide the information to analysts, to the readers of our financial statement, to our owners, and so that's ongoing. But at this time we do not expect to change, if we do, it likely will be with the New Year.

Phil Cusick – JPMorgan Securities LLC

Thanks John.

Operator

Our next question is from Jonathan Chaplin of Credit Suisse. Please go ahead.

Jonathan Chaplin – Credit Suisse Securities

Thanks, couple of quick ones, if I could. So firstly, it looks like your smartphone sales this year are trending well below where they were at this point last year. I'm wondering if that means we are on track to do even less than the 25 million smartphone sales that you expected for the year or if you are just expecting a blockbuster fourth-quarter with the new iPhone launch?

And then I'm just wondering if you could give us some context around what to expect for EBITDA margins? Given that trend, it seems like we should see an even lower upgrade rate next quarter, so sort of a seasonally up quarter for upgrades and with the iPhone launch you should be even low next quarter, but expect margins to be even higher? And then I'm wondering what they could potentially be in the fourth quarter as well? Thank you.

John J. Stephens

Okay, Jonathan, good to hear it from you. a couple of things, one on the smartphone upgrades and sales, a couple of things, one, we are seeing our policy kick in, change in our policy we told you about last year, we told you we're going to grandfather our customers in and that's now taking hold, and I think you're seeing some effects of that. Quite frankly, I think in the first six months, our outsourcing effects of what would be considered a very healthy upgrade cycle fourth quarter of last year, particularly when the old upgrade policy of the shorter timeframe was still in place.

So I think we're seeing, we're getting some of the benefits of what was upgraded in the fourth quarter last year is – helping lower or slow some of the upgrades in the first and second quarter of this year. We're not going to give guidance on specific EBITDA margins or upgrade cycles for the second half of the year. we are going to – we are sticking with our upgrade cycles being flat year-over-year. I openly recognized the fact that the map of the upgrade process is that we are running at a rate, trend rate for the first two quarters below that. but as we get these devices and have the seasonality of the holiday selling season, we will see an uptick and we're comfortable with sticking with that guidance that's out there.

Jonathan Chaplin – Credit Suisse Securities

Thanks, John.

John J. Stephens

As far as EBITDA margins, team did great – feel we're good about where they are at and about all the items that the actions that the team took to get there and there I feel we're comfortable about the fact that their – on solid business focused, customer focused strategies, things that we can do at the end, but we're going to stick with our margin guidance that we're going to grow EBITDA service margins year-over-year and that we expect that to be greater than 40%, and I understand how the comparisons look today, but we're going to stick with the guidance we've done out there.

Jonathan Chaplin – Credit Suisse Securities

John, one point of clarification quickly, when you say sticking with guidance on smartphones, do you mean, you're still sticking to 25 million smartphone sales for the year. The upgrade rate has to be down year-over-year right?

John J. Stephens

Yeah, so John, you make a great point. I appreciate the clarification. I think it will be – the year would be flat year-over-year at 25 million.

Jonathan Chaplin – Credit Suisse Securities

Got it.

John J. Stephens

So your comment is correct.

Jonathan Chaplin – Credit Suisse Securities

Got it. Thank you so much.

John J. Stephens

Thank you.

Operator

And next, we'll go to Jason Armstrong with Goldman Sachs. Please go ahead.

Jason Armstrong – Goldman Sachs

Great, thanks, good morning. Maybe just a follow-up, there is obviously you're getting a lot of questions on sort of the upgrade cycle out there, and John you just gave a lot of good data points. I think people probably still wrestle with, is this the result of policy changes versus is this just new handset availability or lack thereof, maybe another way of attacking this is, are you seeing notable changes in the percent of subscribers that are eligible for an upgrade at this point, but are postponing decisions? Maybe that would be helpful as sort of gauge to what to expect of the next several of quarters. And then just second quick question, the union deal you recently signed, I'm just wondering if you talk us through benefits from that deal and how they may change the cost structure? Thanks.

John J. Stephens

So with regard to the new – the change in the trend for upgrades, let me deal with it this way. First of all, we're into one full quarter here with regard to – this is the first quarter where the upgrade policy change has really impacted us. And as I mentioned before, the fourth quarter last year was unusually high, so there is some impact I think on the first and second quarter from that. So it's early in this process, but clearly, we believe that the upgrade policy is impacting – the new upgrade policy is impacting upgrade cycles and it’s helping us control that process and improve margins.

Secondly, there maybe some impact quite frankly of the change in upgrade fee. It was a small change, but we – it was an increase of $18. I can’t suggest you that we can measure that.

Third, there maybe some impact from customers deciding to wait until the new device comes out. I can’t speak to that, it’s too early at this time. I assume we’ll know that they will have some better insight in that after the device may come out. So I guess the key for us, (inaudible) walk away with this is, it appears our policy is working, it appears our plans are working, we need to continue down this path. But when you look at the upgrade numbers and then tie in the churn, I feel really good about the policies are [working] in a customer appreciative or a customer friendly way.

So with regard to our recently announced tentative agreement with both the Midwest and our legacy T employees, I’d just suggest you that we’re appreciative of their leaderships bargaining in good faith, we are appreciative of the efforts that both teams made in coming to a resolution. And quite frankly, I want to point out the resolution in these contracts is right about the same week that we resolved these contracts three year ago. So it’s really good to have a quality working relationship with your employees and their representatives.

We will let the details come out from the union and we will let them go through the process of ratification with the employees, which we are very optimistic about. But needless to say, we think it’s a fair deal for some valid employees, but we also think it continues to make a rational progress in not only the way it struck, but the benefit and the cost structure. So yeah, it’s a good fair deal and it gets our employees interest and our shareholders interest aligned. More details to come out and hopefully we’ll have an announcement and ratification coming soon we’re hopeful for that.

One other thing I want to add to is, if we're fortunate to get these, which we expect, we’re fortunate to get these contracts ratified between these two contracts and the IBEW extension we've signed a few weeks ago that would bring 25,000 or more than 25,000 of our employees that whose contract terms are coming due this year under new contracts. So we’re really making good progress on that front.

And we look forward to working with the representatives from the West and the East, and quite frankly the Southeast in coming to resolutions on contracts with them. We're [pause] about this – we have a lot of good people here, and we're looking forward to keeping them working.

Jason Armstrong – Goldman Sachs

Okay, thanks John.

Operator

Our next question is from David Barden with Bank of America/Merrill Lynch. Please go ahead.

David Barden – Bank of America/Merrill Lynch

Hey guys, thanks for taking the questions. John, maybe just a follow-up on the labor point. I was surprised to see that the headcount was down a little over 4% in the quarter that's one of the bigger headcount changes we've seen in a few years, and I guess, if you could elaborate a little bit about what the – where that – where that was going on, and what the game plan behind the headcount is, both this past quarter and maybe for the rest of the year.

And then just second, we've talked a lot about – and potential have a benefit down the road for an AT&T. Are you guys able to share any statistics right now about for instance what percentage of the base would actually, could actually generate over hedge either now or in the near future, the next year or two. I guess one of the questions everyone has is, we hear about the averages being large, but a lot of those people are still on a limited plan. If your average customer is only using 300 megabits, 400 megabits or 500 megabits a month and that's growing 30%, 40% for the next few years, it could be many, many years before these tier plans kind of generate profits. Could you help kind of clear that issue up for us? Thanks.

John J. Stephens

Okay. First and foremost, on the employee count information if we could, we'd like to make sure we're – if you will doing comparative numbers here. We did pull out the Ad Solutions employees from our employee base because of the transaction. And I think that maybe the biggest – if we're talking about a 4% change, it would have to be that, that explains the difference and that was probably – we're probably be close 3% of that 4% change.

David Barden – Bank of America/Merrill Lynch

Okay.

John J. Stephens

So, I am not sure of which – if anybody think that really the impact of what we're talking about. With regard to tier data, understanding your question, I guess a couple of points. One, we've gone from zero to 27 million in two years. So, we're pleased and it appears our customers are pleased with it. Two, customers are choosing the higher tier plans, whether that would be the 3 gig or the 5 gig plans with – and a clip of more than 70%. And so we're doing well and they are choosing to have that usage available to them without additional charges. That's all happening in this churn environment.

So once again, it appears that's all going well. We don't give usage base and we're not going to give breakage information out. But I can tell you, we're also comfortable with this because of our recent changes to the buckets where we increase the available amount of data to them with a slight increase in price. And the fact that that's been taken into account with low churn, is just another encouraging piece that we can serve customers well and still get ourselves set up for revenues that are going to be tied to usage, which will then be tied to our capital requirements and a really profitable situation.

On the unlimited, I really think the unlimited is a kind of issue that we've really handled. And specifically, we've handled it because of our bit rate management program. And so those extraordinary consumers have been addressed and the process is in place for more than a few months now. And quite frankly, once again, I look to churn as a indicator of how that's being accepted and how that's impacting our customer base, and we feel good about the progress we've made there.

David Barden – Bank of America/Merrill Lynch

Okay. Thanks, John. Yeah, I think that that change in the employees was going to be the difference – the directory, so I appreciate your help. Thanks, John.

John J. Stephens

No problem.

Operator

And next, we'll go to line of Tim Horan with Oppenheimer. Please go ahead.

Timothy Horan – Oppenheimer & Co.

Thanks. Good morning, guys. John, I seem to beat a dead horse here, but on smartphones the $25 million in sales maybe a touch more color on the outlook. Do you think, you can continue to control that over the next couple of years and at the same type of pace and I guess the latest of that with the upgrade fees and what you're seeing around churn? Do you think, you can possibly still raise prices there maybe up to around the $50 price point or so? And then lastly on the handsets, it does seem like the – all the subsidy is coming down I guess for the non-iPhone devices the average selling prices seem to be coming down for Android devices. I'm wondering if you are seeing any benefit from that? Thanks.

John J. Stephens

Yeah. So Tim, I guess just probably more generally than you prefer, I mean the handset as the smartphones and the subsidy issue is day-in and day-out management issue, management intention and focus. So we're looking at all kinds of things.

I would suggest to you that we believe that this is just the first quarter of the upgrade policy change being fully in effect. and so we are optimistic about our ability to continue to manage it, to measure it, to provide customers, not only to enforce it but also to provide customers the opportunity to buyout, if they want to upgrade before their cycle times. and we are in place to do that. So we're optimistic about the ability to do that. now, we'll have to do that for ourselves, for our shareholders, for the analysts. But we believe we're on track to do that.

secondly, with regard to the environment as new handsets come out, as things get more competitive, we believe there will be more rationale pricing in those – in that market and we'll be able to either through our own disciplined actions of pricing [tags] or our own disciplined actions of seeking out more cost advantageous devices. We need to continue to focus on lowering the costs or managing the costs of those subsidies.

At the same time, we have some very good customers who are willing and who desire, who want handsets, and are willing to entering the contracts and work with us and provide us good monthly ARPUs that we're going to be more than happy to continue work with them and continue to hold on to that customer base.

So it's a day in, day out focus of management. But it's going to be one that we're going to play out in quarters to come, just to prove to you that we can continue this good progress we've made this year, and specifically this quarter.

Timothy Horan – Oppenheimer & Co.

Thank you.

Operator

Our next question is from Michael Rollins with Citi Investment Research. Please go ahead.

Michael Rollins – Citi Investment Research

Hi, good morning. Thanks for taking the question. I was curious if you could talk a bit more about, how do you think about the first half of free cash flow performance relative to the guidance of $15 billion to $16 billion for the year? And within that context maybe you could discuss directionally how you are seeing capital spending for wireline and wireless, the implications for cash taxes going into next year? And then last and not least is, just pension contributions and given the new laws, should we be thinking any differently about the way you're going to be approaching the pension? Thanks.

John J. Stephens

Thanks, Michael. We're going to stick with our $15 billion to $16 billion of free cash flow guidance or the run rate ahead of that, that's evident from our numbers, and we're pleased with the fact with where we are at. But as we've mentioned, we're going to stick also with our CapEx guidance. And so we do expect trending up in CapEx to second half of the year. That's not a – that's only because in the first half of the year, our team and network team and others that use CapEx were real efficient and real careful.

And if you will, spent the money like it was their own to be careful in managing it, and so they've spent a little bit less, but they still got their work done. And now that we've got that efficiency, we're probably going to return more to a kind of normal spin, which will not only have a tick up in CapEx, but we'll have some – will also impact free cash flow.

Our cash tax situation isn't something we talk about on a quarter-by-quarter basis, I would suggest you, I think the situation for us is a little different over the long-term than others. First and foremost, most depreciation has gone away, but that impact will be spread over three years for us, because of the way to estimate favorables where.

Secondly, for this year, we've got some kind of the unique benefits that we are going to get. The contract termination payments in the transfer spectrum we made and the pension funding we did in the fourth quarter of last year, we'll get the cash tax benefits of that this year.

Probably more importantly tough is, if you think back to our – an IRS settlement we entered into in September of 2010 for about $8 billion. If you're familiar with that, you'll realize that there is about $600 million a year of cash tax benefits that are coming out of that settlement and that will give you every year – through the year, I think 2022. So, that settlement, which provides cash balance into the future.

And then lastly, if you've seen the spectrum purchases we made, going all way back to the auction process back in the '08 timeframe, and all the spectrum purchases since, we don't deduct or amortize those for book purposes, but they are deductible and amortizable for tax. So, we got a lot of things going on that are going to allow us to manage cash taxes and we put a lot of focus on that.

With regard to the pension funding in the highway bill/pension funding, a lot changed. We don't have any inventory contributions to our pension plan this year, so for 2012 it doesn't affect us.

For 2013 going forward, certainly it could affect us, but it's too early to talk about that. We have to see how our return on assets do this year. We have to see how our liabilities work out. I will tell you, our focus on the pension play is really to make sure our employees know that it's secure, and that it's funded, and that we're efficient in doing it. And that is as much of focuses as the change in the highway bill pension loss.

Michael Rollins – Citi Investment Research

Thanks John, it's really helpful.

John J. Stephens

Thanks Mike.

Operator

And next we go to Brett Feldman with Deutsche Bank. Please go ahead.

Brett Joseph Feldman – Deutsche Bank Securities, Inc.

Thanks for taking the question. I just want to follow-up a little bit on CapEx, it does seem like we're going to see a step up in the second half. Could you provide a little color around, maybe where we're going to see that? It seems that it would likely be on the wireless side in light of your LTE build out plan, but there are some wireline investments you need to make, that will be helpful color.

And then just bigger picture, correct me if I am wrong, but I believe you're doing a fairly dense initial deployment of LTE, many are hitting quite a few sites or most of your sites with that build out. So how do we think about capital intensity in the wireless business after that initial deployment is complete. Could we see CapEx tick down or are you relatively comfortable with the level of investment in the business and you would redirect this dollars and to say capacity deployment?

John J. Stephens

Great, let me try to (inaudible) so one at a time, first of all we do a tick up in there, a step up in span of the second half of the year in CapEx, yes – we expect that fits with our – sticking with our guidance of about $20 billion.

Secondly, I think the – while we don't give specific predictions of the break down quarter-by-quarter, I think it's fair to assume that in the first half of the year we spent about 60% or so, close to 60% of our CapEx in wireless and you could expect that that will continue. I don't want to give any guidance that would move you from that.

I think the logical pieces there, things like the U-verse build and the fact that we really are, don't have any extensive new living units coming new that is in that area, the consumer is for success phased outs, it's not as much build, explains why some of the wireline maybe moderating, and the LTE build and accomplish that process. And the importance of that too is, it shows, may give you some insights of the why CapEx on the wireless side maybe increasing. We are doing a very dense bill, we think that's the way to give the best quality service to our LTE customers, and we think in the long-term that's going to really help in all aspects. So we believe that's the right strategy, we stuck with that, and we're going to stick with it, and I believe the customers are going to win, because that we decided to make that our strategy.

With regard to so to speak next year and future years, when you think about the fact that the LTE build is well on its way, I think we mentioned 90%, we're almost 90% of our data traffic is on enhanced backhaul already. As we roll it out, yes there is a logical thought that maybe you can lower CapEx and you just going forward. But we are sticking with our guidance of mid-teens as a percentage of revenue, and that's really because we've got a lot of great opportunities in this business, we believe in the business, both in the wireline and the wireless business.

And so, we want to make sure, we guided that – we believe we'll find good opportunities for that investment, I already discussed this specifics, but I think we're going to stick with the guidance. I understand your reason, and I think it's logical that you would think there might be a step down, we're not guiding in that direction.

Susan Johnson

Thank you, Brad, and John I think we've got time for just one more question.

Operator

And that would be from James Ratcliffe with Barclays. Please go ahead.

James Ratcliffe – Barclays Capital

Good morning, thanks for taking the question. If we just look at wireline for a second, and do you can help us unpack how much of a role international had in the result of this quarter, and what the [recurrency] was a drag year-on-year? Thanks.

John J. Stephens

Quite frankly James, I think you're probably well aware that our international exposure is really based on a U.S.-based companies going international, and it's really not significant, the biggest international exposure we have quite frankly, is in our equity income from our investments in Central and South America through our holdings and (inaudible) that probably is the biggest Forex impact. I will tell you on the business services revenue, there was an impact from foreign exchange, but I would suggest you that I don't think it changes the story for us, on that business services revenue. And I don't want to hold that out as the story changer. I think it's just much more about our businesses being careful and a little hesitant because of the uncertainties of budget deficits, tax laws and other things, and maybe that's our conjunction, that's what we believe. So it's more of that than necessarily a foreign exchange hitting our business services revenue line.

James Ratcliffe – Barclays Capital

All right. Thank you.

John J. Stephens

Thanks, and let me close up here. First and foremost, I want to thank you all for being with us this morning. We delivered a strong financial quarter with record-setting performances in wireless and another strong showing with U-verse. This just only goes to build our confidence as we head into the second half of the year. I should note with you that next quarter, we will report our results on October 21 – excuse me, on 24, October 24. Our earnings call that day will begin at 9 AM Eastern or 8 AM Central, little bit earlier.

Once again, thank you for being on the call. And as always, thank you very much for you interest in AT&T. Have a good day