

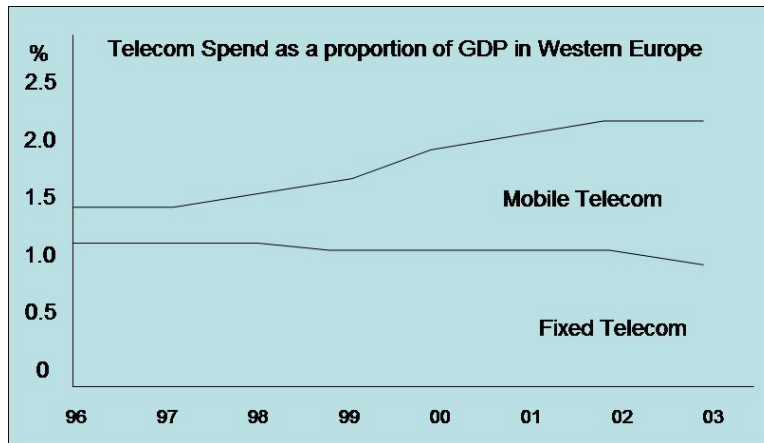
## EUROPARTNERSHIP WHITE PAPER

### The switch to mobile phones calls for an agile response from the incumbent European Telecommunications industry

Fixed-line operators in developed economies are facing a future of little or no revenue growth as their traditional core business – voice telephony – is cannibalised by mobile telephones.

Years of state monopoly and evolutionary change have left fixed-line voice services ill equipped to meet the dual demands of the rapid technological shift and market liberalisation. Contrast the shorter innovation cycles for mobile telephony – already into its 3Generation (3G).

With few exceptions, incumbent operators so far have failed to renew revenue growth in their core fixed-line businesses. While broadband helps, it is still a long way from becoming a mass-market product capable of compensating for declining voice volumes. It also cannibalises second lines and dilutes profit margins.



Source: OECD: OMSYC (Observatoire Mondiale des Systemes de Communication)

Loss of fixed voice in some countries is now very pronounced. Substitution by mobile is no longer circumscribed to marginal segments. As the youth segment ages, its usage patterns continue to favour mobile voice telephony, and this behaviour is spreading to more of the population – as, indeed it is to other markets such as the Internet, digital cameras, MP3 players, and flat-screen TVs.

All of these adoption behaviours have a flip side: the obsolescence of previous technologies, products, and services.

Is the fixed-line voice service also becoming obsolete? Fixed-line operators have been on the defensive to date. No operator disputes that minutes of voice usage in fixed-line infrastructures and the number of access lines have dropped in recent years. However, most say publicly that cannibalisation is only a marginal issue; operators argue that DSL roll-out combined with tariff innovation will more than offset declines in fixed-line voice.

Further analysis, however, suggests that these actions cannot satisfactorily reverse the erosion in profit margin contribution that the combination of losses in market share of voice and pricing discounts provoke.

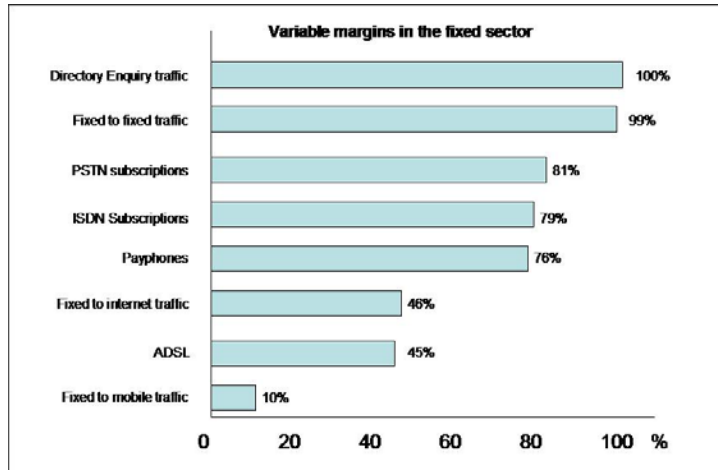


Chart summary: DSL roll-out and data services will not offset losses from the decline in traditional voice

There is a model that simulates the redistribution of the total minutes of voice telephony, both fixed and mobile, in a typical European market. It considers the dynamics in the residential consumer versus business markets for voice, and within these markets it considers differences among the broad customer segments that base their choices on brand, overall value proposition, and low prices when purchasing telephony.

For the sake of simplicity, consider a market structure similar to that which exists in most European countries: three fixed-line operators (one dominant incumbent and two competitors) and three mobile operators (a less dominant but still superior incumbent, plus two others). Typically, the nature of competition exhibits the following characteristics:

Fixed line to residential customers			Mobile to residential customers	
<i>Brand equity</i>	Incumbent has superior brand equity	✓	Incumbent has mobile offer, slightly superior brand equity	✓
<i>Value proposition</i>	Incumbent's value proposition is superior, but nearly matched by competitors'	✓	Incumbent' value proposition roughly equal to competitors'	⇒
<i>Price</i>	Incumbent has higher prices than competitors'	×	Price Points are similar across all operators	⇒
Fixed Line to Business			Mobile to Business	
<i>Brand Equity</i>	Incumbent is superior to competitors – but less so than residential	✓	Incumbent has superior brand equity to competitors'	✓
<i>Value Proposition</i>	Incumbent's value proposition is nearly matched by competitors'	⇒	Incumbent has superior value proposition through account management across both platforms	✓
<i>Price</i>	Price Points are similar for all operators	⇒	Price Points are similar for all operators	⇒

1. Fixed-line voice to residential consumers. The incumbent usually dominates fixed-line voice to consumers in terms of market share, because of its historical legacy and a general reluctance to switch on the part of consumers. It benefits from superior brand equity, has a

superior or matching value proposition to that of its competitors, and generally prices at a premium.

2. Fixed-line voice to businesses. The dominance of the incumbent in the fixed-line voice to businesses is less pronounced than in the consumer market. Its brand equity is sometimes matched by that of international competitors, the competitiveness of its value proposition varies depending on the exact requirements of business customers, and its ability to price at a premium varies.

3. Mobile to residential consumers. In most European countries the incumbent and a second mobile operator compete neck and neck. Their brand equities are similar, while the incumbent's value proposition is often behind that of very large multi-country operators; pricing is very similar.

4. Mobile to businesses. Incumbents take advantage of substantial account management resources to lead in the sale of mobile to businesses. In this market, incumbents have similar brand equity to that of their close followers, but benefit from a perceived superior value proposition. Prices are similar across operators.

Given this succinct characterisation, we can think about three scenarios.

The first represents a country where the incumbent dominates fixed-line voice to both consumers and businesses and also has a strong leading position in mobile. As inputs to the model, we characterised the competitors' brand equity, value proposition, and level of pricing aggressiveness as indices. These indices are based on the results of primary market research carried out in Europe and calibrated against typical market shares observed.

The second represents a country where the incumbent operator has a strong position in fixed-line voice to both consumers and businesses, but a relatively weak presence in mobile.

The third scenario represents an incumbent with a strong position in fixed-line voice to consumers, a weakened competitive position in the business market, and also a relatively weak presence in mobile.

The findings suggest an important loss of voice minutes by incumbents in the consumer market and a less severe decline in the business market. If competitive mobile operators were to turn around their traditionally weak processes to serve corporations, in particular across multiple countries, domestic incumbents might also see an erosion of their voice telephony among business customers. If the incumbent's position in the mobile market is weak, as is the case in some European countries, the overall loss in share of minutes is severe.

Some incumbents risk losing a third of fixed-voice minutes unless they can turn around their inferior consumer value proposition and, in some cases, business value proposition. This erosion would be even more extreme if independent mobile operators across Europe were to accelerate cannibalisation of fixed voice through rapid price declines, as we are currently witnessing in Scandinavia and, less severely, in the U.K.

The output of this illustrative model is intuitive, but only directional. However, it shows that the incumbents' neglect of their fixed voice businesses, while pinning their hopes exclusively on DSL deployment and pricing plans, makes them vulnerable to the more innovative value propositions and progressive price declines of mobile operators.

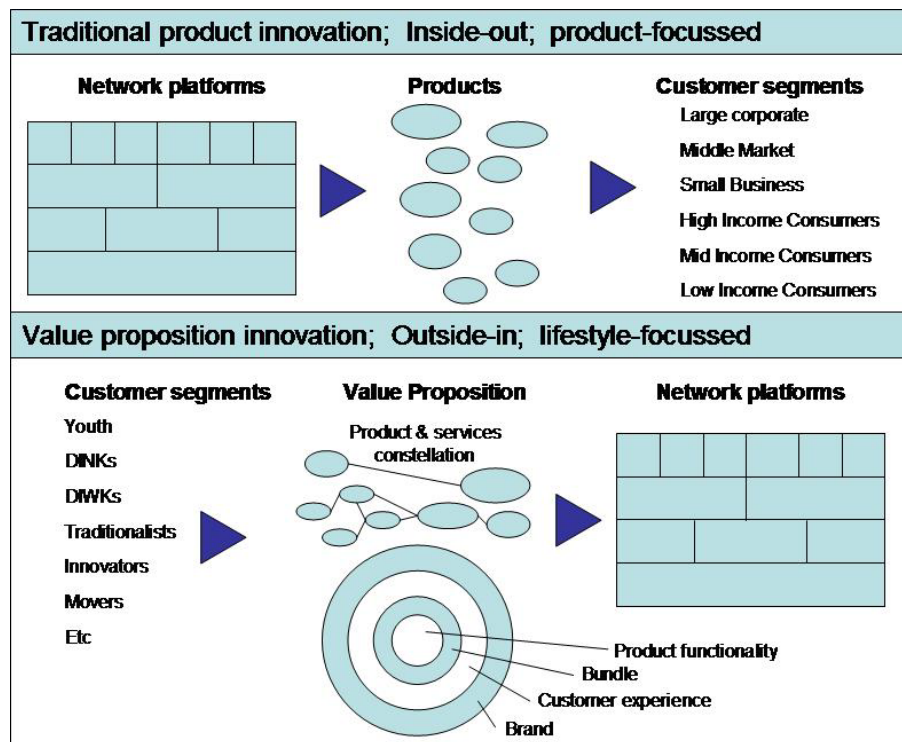
If independent mobile operators choose to steal market share of fixed voice, incumbents will face a difficult dilemma: respond to defend their mobile businesses but in so doing accelerate the cannibalisation of their own fixed-voice service; or not respond and see both their businesses suffer. Under this scenario, the answer to the question posed earlier – “Is fixed-line voice becoming obsolete?” - is almost certainly yes.

*The innovation mandate*

There is a different path. Fixed-line operators can respond by fundamentally changing their business designs to embrace innovation, not simply in terms of application or content (the Internet road is choked with failed business designs that bet on “killer applications” or “killer content”), but rather innovation of the interface between customers and equipment. This would require adopting the same attitude as mobile operators to equipment manufacturers – that is, establishing genuine partnerships as opposed to just customer versus supplier relationships – to bring waves of lifestyle value propositions that consumers will want to engage with.

In contrast to traditional segments, such as “high-income consumer”, an example of a lifestyle segment might be “young people sharing an apartment” - exemplified by the TV sitcom “Friends.” A coherent value proposition to this segment should define not just technical features, but also values and emotional characteristics such as the communication message, channel placement, brand position, and service attributes.

The salient questions about this segment of customers change from what product have we that we can sell towards: What are their aspirations and their frustrations? What benefits are they seeking? And, thus, what drives their purchase decision?



For young people sharing an apartment, important lifestyle attributes might be that they have free time only late at night and on weekends; they're away from home a lot; they organize a

lot of events; they use a laptop as a personal stereo; they want to be reachable by friends at all times; and they're willing to spend a premium on those things they care about.

A relevant value proposition could be a functional but fun, youth-oriented marketing communication, underpinned by a DSL connection with multiple phone lines, combined with a home wireless connection, personalised billing, a choice of handsets and devices linking seamlessly with each other, and a set of pricing options tailored to this segment.

Fixed-voice innovation must be differentiated from mobile characteristics. Price innovations in fixed-line and fixed/mobile bundles are not effective alternatives to mobile, because their branding, overall value proposition, and channel presentation make them second-rate relative to the newest mobile handset offered by strongly branded mobile operators. Selling fixed voice on the basis of lower voice cost only encourages a spiral of price declines.

Research in the U.S. and in Europe reveals a strong pent-up demand for fixed voice propositions not currently available, including higher functionality in handsets combined with more intuitive navigation, CD sound quality, and interactivity between handset and TV, among others.

Subscriptions for these new value propositions could increase average revenue per user by amounts ranging from 20% to 40%, depending on country characteristics. But their biggest impact is the potential ability to reverse the effects of the eroding partition between fixed and mobile telephony, and to rejuvenate fixed voice.

The fundamental underlying question is which of the incumbent national telecommunications companies has the organisational agility to meet the challenges spelled out by this analysis.