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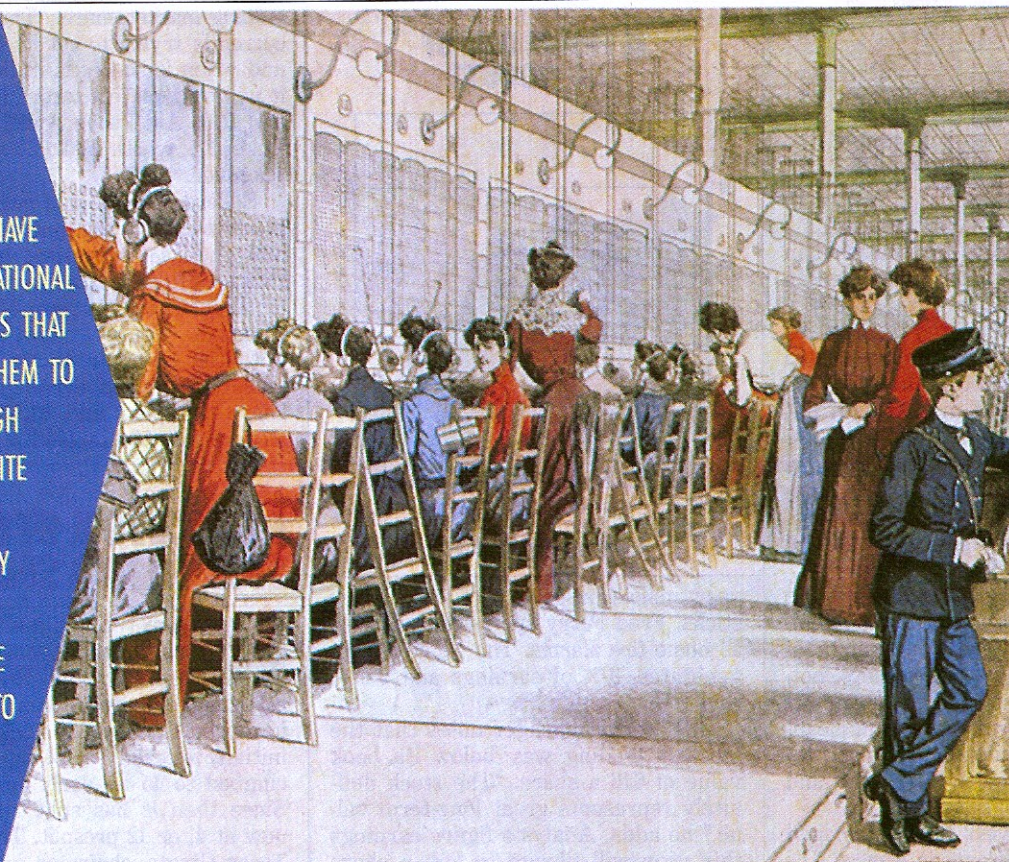
WAKE-UP CALL

Rivals are moving in fast on Europe's giant phone monopolies. Their survival depends on massive cost-cutting and adapting new technologies. Are they up to the job?



THEN

FOR YEARS, EUROPE'S TELECOMS HAVE ENJOYED NATIONAL MONOPOLIES THAT ALLOWED THEM TO CHARGE HIGH RATES DESPITE LAGGING TECHNOLOGY AND GAVE THEM LITTLE INCENTIVE TO CHANGE



Now

WITH THE EUROPEAN COMMUNITY SET TO OPEN THE \$130 BILLION MARKET, THE TELECOMS ARE SCRAMBLING TO CATCH UP WITH MORE SOPHISTICATED CORPORATIONS

Elfriede Badmann knows how bad Europe's phone companies are. She would tell you if she could. But she can't—her phone service has been cut off.

Between January and June, Germany's national operator, Deutsche Bundespost Telekom, sent the 78-year-old Essen pensioner bills amounting to \$10,000. Since Badmann's monthly bill had averaged \$35 for the past 18 years, she claims it was a computer error. But DBP Telekom's outdated systems can't produce an itemization of the charges, so she can't rebut them. When the company demanded payment anyway, Badmann, who has diabetes, was forced to cancel service. Telekom then blocked an emergency beeper her family tried to have installed, pending a downpayment on the phone bill. Telekom's behavior, says neighbor Gabriele Knorr, is "obscene." Telekom says such cases are rarely due to technical error.

BRUTAL TRANSITION. After years of such appalling service, Europe's national telephone monopolies are about to get their comeuppance. Their lagging technologies, surly clerks, and high rates make them sitting ducks as tough new competition readies to trample the Continent's \$130 billion industry. From AT&T and Sprint to British Telecommunications and Daimler Benz, ambitious rivals are lining up to exploit new technologies

WAKE-UP

and blast open the loopholes in regulations. Already unshackled in such fast-growing sectors as data and mobile-phone services, the European Community last June decided to open the floodgates on the remaining 80% of the market and deregulate public voice calls in 1998.

With time running short, the national monopolies are scrambling to restructure tariffs, shake up bureaucratic cultures, and modernize their networks and services. Demands for greater efficiency will only mount as these state-owned dinosaurs move to private ownership—starting next year with the Dutch, Danes, and Italians. Waiting until 1988 to react to fast-changing markets "would be lethal for Europe's economy," says DBP Telekom CEO Helmut Ricke.

But it will be agonizingly tough to untangle Europe's telecommunications

problems, much less to enter the age of the Information Superhighway. As it is, Belgians must wait 20 days for new phone service, while in Italy, regular phone calls often go dead. Even after recent cuts, long-distance rates are sky-high (chart, page 40). In a typical case, Rank Xerox Ltd.'s \$45 million annual phone bill in Europe is triple the charges for comparable volume in the U.S. And don't ask about corporate services such as call-forwarding, tie-lines, and itemized billing across borders. Europe's public networks can't handle them.

The backwardness of Europe's telecom monopolies—often known as PTTs for post, telephone, and telegraph—is more than just an irritation to users: It is hampering Europe's ability to compete. With phone traffic growing only 12% annually, or less than half the rates of the U.S. and Japan, the disparity in

YET TO COME

OPERATORS THAT NOW DOMINATE EVERY NICHE WITHIN A COUNTRY ARE LIKELY TO BE REPLACED BY A PATCHWORK OF ALLIANCES THAT BLURS NATIONAL IDENTITIES

CALL

AS RIVALS CHARGE INTO THEIR MARKETS, EUROPE'S TELECOMS ARE RACING TO MODERNIZE

prices and services is sapping Europe's economic vitality. Concludes Volkswagen communications systems chief Klaus Schulz: Without swift changes, European industry "has no chance to stand up to the U. S. and Japan."

It's true that Japan jumped on the privatization bandwagon more quickly than Continental Europe, launching a partial privatization of phone giant Nippon Telephone & Telegraph in 1985 and licensing new competitors in the long-distance market. But Japan's modernization moves have failed to keep pace with the blistering speed of global telecommunication innovation because of the heavy hand of regulators. It has lost momentum in new products, services, and in the spread of cable (page 43).

In Europe, the transition to the new order promises to be brutal. Most PTTs are padded with too many workers that

postwar social systems make hard to shed. Yet, by 2000, these companies may have to jettison as many as a fifth of their 1 million total employees, tearing at traditional social contracts and forcing wrenching changes. Some smaller operators could disappear altogether. Executives have no time to dawdle. Large corporate clients are already deserting them at the first appearance of competition. "There's a real threat on the horizon if we don't get our acts together fast," concedes PTT Telecom Netherlands President Ben Verwaayen.

Europe's monopoly-busting is likely to be even more jolting than the U. S. breakup of American Telephone & Telegraph Co. in 1984. While the seven Baby Bells retained monopolies on local phone service in their regions, every sector of Europe's markets will eventually be pried open to competition. Until then,

they'll try to milk their monopolies for all they're worth. But that will be a short-lived refuge.

When competition really heats up, national carriers used to dominating every niche within their borders, from local to international calls, from satellite to mobile services, will be ripped apart. In their place will be a patchwork of alliances that blur their national identities. Some national operators may be reduced within a few years to mere holdings of stakes in various local, mobile, and international networks and services. Already the Swiss, Dutch, Swedish, and Spanish PTTs have hived off business services into a common venture called Unisource. In uneven steps, Europe will enter the brave new world of telecom. Says Paolo Guidi, president of Sprint International: "Once competition starts, nothing can stop it."

HOWLS OF COMPLAINT. The sense of urgency was obvious on Dec. 7, when France Telecom and DBP Telekom announced their plan to merge private business, data networks, and international and other services. It could erect a barricade around their combined territories, controlling 40% of the Continent's telecommunications lines and population. With feared U. S. competitors already eating into both carriers' revenues, their run-for-cover strategy is hard to miss. "If AT&T is let loose in Europe un-

checked, no eye will remain dry," explains Germany's telecom minister Wolfgang Bötsch. In fact, the new couple is negotiating anxiously to enlist formidable AT&T as a partner in Europe, rather than risk competing against it.

Even lacking a pact with AT&T, the Franco-German accord has competitors howling charges of antitrust, followed by appeals to Brussels to block the deal. "We've seen the shape of the beast, and it's pretty horrendous," says Iain D. Vallance, chairman of British Telecommunications PLC. Ironically, it was his own alliance last June with MCI Communications Corp. to capture multinational corporate clients that triggered his neighbors' defensiveness.

Assuming the deal is cleared, France Telecom and DBP Telekom have a bit of breathing room to mesh tricky technologies, rates, and company structures. The EC decision to postpone competition for public voice services until 1998 cordoned off nearly 80% of the market, forestalling the type of far-reaching deregulation begun a decade ago in the U.S. or Britain. The PTTs' combined market share of 95% in 1992, forecasts market researcher Yankee Group Europe, will fall only gradually, to 86% of a \$175 billion market by 1997.

But even as the Europeans run to catch up in basic services during their four-year reprieve, U.S. operators are amassing a long lead in the next generation of multimedia. Several are already committing billions to roll out the Information Superhighway that will put them ahead in interactive shopping and other services that can then be deployed in Europe. The Continent's operators, meanwhile, are just starting tests to exchange picture and data signals among incompatible networks.

INCHING AHEAD. They're behind because they have had little incentive to change. No aggressive cable-TV companies are prodding them, as is happening in the U.S. On the contrary, the local PTTs control most of the cable systems. Moreover, no major European country except Britain and Sweden allows



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SERVICES MARKET**

telecom competitors to own their own infrastructure. Instead, they must lease lines from the PTTs—and live with usurious rates and other tactics that impede competition. With no rival ownership of the networks, warns Paris network consultant Geoff Gould, "Europe is setting itself up for disaster" in the next round of battle.

Not only is the lack of competition holding back innovation but it's also stunting growth. If restrictions like those on infrastructure aren't lifted, Europe's telecom market will be limited to barely half the \$360 billion it would grow to under fully open conditions over the next 20 years, says Analysys Ltd., a consulting firm in Cambridge, England. For that reason, officials are expected next year to allow independent cable companies, railways, and other utilities

that own telecom networks for internal use to sell services to others.

Clearly, some governments are inching ahead. Last summer, the Dutch government gave its blessing to a rival consortium to start service in 1995. More surprising, France in September authorized a large water utility to install a new radio-transmission system in a Paris suburb for delivering local calls to France Telecom customers—posing the first threat ever to a Continental operator's core residential market. "We must have new actors investing in new technologies," avows Bruno Lasserre, France's telecom regulator.

He need only look across the channel to see the benefits. Since 1991, when Britain started granting licenses to newcomers—30 so far—the island has been abuzz with new phone companies, from local services running over radio waves and cable-TV lines to international connections via satellite. Energis, owned by local electric utilities, has cut costs for its 1,200-km fiber-optics network to a mere \$150 million by piggybacking lines on its parents' utility pylons. That will allow it to offer cheap long-distance calls and multimedia services. The new competition, which could knock British Telecom's market share from 90% to 80% in the next year, has inspired BT to invest in such advanced services as video-on-demand, set to debut next year.

Deregulation has impact far beyond technology. It raises much broader challenges for European industrial and social policy. PTTs, flush with monopoly profits, have long provided politicians a bottomless pit of cash to fund ambitious industrial policies, from propping up Spanish switchmaker Amper and France's Groupe Bull to retooling dilapidated eastern Germany. But after the final payoff from privatizations—proceeds could reach \$45 billion over the next three years alone—that source will dry up as the operators transfer out of state hands.

Along the way, the social fabric of some of Europe's most enduring institutions is sure to unravel. To match

EUROPE'S PHONE GIANTS FACE HURDLES

EFFICIENCY IS POOR...

EMPLOYEES PER 10,000
ACCESS LINES, 1992

U.S. AVERAGE	46.8
DBP TELEKOM	64.9
BRITISH TELECOM	63.4
STET (ITALY)	53.1*
TELEFONICA (SPAIN)	52.8*
FRANCE TELECOM	51.8

...AND RATES ARE HIGH

COST OF A 10-MINUTE
CALL FROM:

PARIS TO ROME (1,350 KM)	\$4.33
COMPARABLE U.S. CALL:	\$2.40
MADRID TO PARIS (1,230 KM)	\$5.61
COMPARABLE U.S. CALL:	\$2.40
FRANKFURT TO PARIS (560 KM)	\$5.06
COMPARABLE U.S. CALL:	\$2.40
LONDON TO ROME (1,740 KM)	\$3.74
COMPARABLE U.S. CALL:	\$2.50

*NOT INCLUDING HEAVY USE OF SUBCONTRACTORS FOR INSTALLATION AND OTHER SERVICES

DATA: SALOMON BROTHERS INC., DAIWA SECURITIES CO., COMPANY REPORTS, TARIFICA/OMNICOM PPI LTD

EUROPE IS STARTING TO LOOSEN UP THE PHONE LINES

FRANCE

- **FRANCE TELECOM** and **DBP TELEKOM** plan to merge data, business networks, and other services
- Privately owned **CGE** to provide residential phone service using new radio technology, posing first local threat to France Telecom
- Third mobile network license to be awarded by regulators in 1994

GERMANY

- Privatization of **DBP TELEKOM** to start in 1996; new competitors form, targeting liberalized corporate services
- Private carrier **MANNESMANN MOBILFUNK** takes 50% of cellular mobile market as a third rival prepares to enter in 1994

BRITAIN

- Cable-TV companies, **CABLE & WIRELESS**, **AT&T**, **SPRINT**, and others expect to win 20% market share from **BRITISH TELECOM** by 1995
- **BRITISH TELECOM** slashes calling charges and is midway through a massive restructuring plan to slash half its staff by 1997

BELGIUM

- National carrier **BELGACOM** agrees to sell 25% of mobile network to San Francisco-based **PACIFIC TELESIS**
- **BELGACOM** cuts international calling rates up to 15% and raises local calls by 20% starting January, 1994

NUMBERS RANK THE DEGREE OF COMMERCIAL FREEDOM EACH PTT IS ALLOWED. SCALE IS 1 TO 10, WITH 1 AS MOST REGULATED, 10 AS LEAST REGULATED

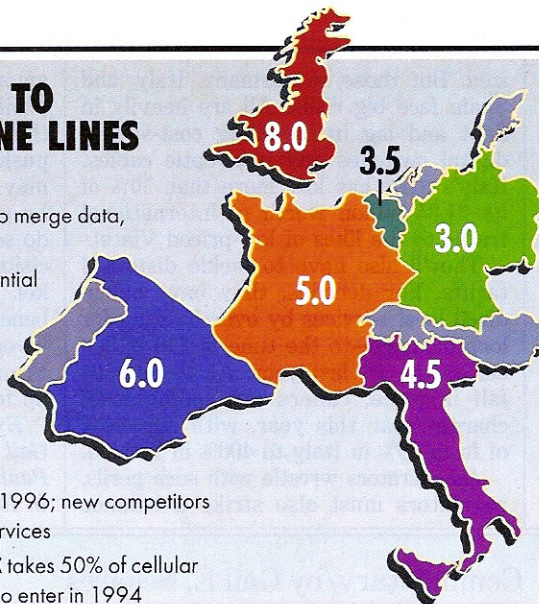
ITALY

- Fragmented public telecom sector to consolidate in 1994 into a single operator as a prelude to privatization
- First competing mobile network license scheduled for 1994
- **PTT** plans a multimedia joint venture with **BELL ATLANTIC**

SPAIN

- **BRITISH TELECOM**, **AT&T**, and **FRANCE TELECOM** stake out local banks as partners to attack **TELEFONICA'S** data network business
- First competing licenses for mobile and data networks scheduled for 1994

DATA: YANKEE GROUP EUROPE, BUSINESS WEEK



the lower costs of rivals, at least 30,000 jobs each at Italy's STET and France Telecom are at risk in the next few years. Rivals say DBP Telekom alone needs to halve its 230,000 staff—not unlike British Telecom, which is already midway through a seven-year plan to slash its peak of 245,000 workers by 55% by 1997. Without similar attention to staffing by other operators, warns London analyst Richard Ryder of Salomon Brothers Inc., "new, leaner competitors will run circles around them."

RAGING FIRES. The politically explosive prescription comes on top of a European unemployment rate averaging 12%. In many countries, executives are hog-tied by civil-service codes guaranteeing lifetime employment, promotions, and perks such as interest-free loans. "I've inherited 40 years of political employment," grouses Bessel Kok, who took over as chief executive officer last year at Belgian PTT Belgacom. More than a quarter of his 25,700 workers are employed as company chefs, architects, garage attendants, and in other unrelated jobs.

The risk is growing in France and Germany in particular that the monopolies' old social charters could impede important changes. In mid-October, 75% of France Telecom's 155,000 workers went on a day-long strike demanding the government rescind legislation that would allow it to swap equity with DBP Telekom and seal the Franco-German alliance. Fearing for workers' benefits, unions called for more walkouts in January. Rather than risk another confrontation like the showdown with Air France strikers this fall, Prime Minister Edouard Balladur backed away from the

plan in November. Now, if France Telecom President Marcel Roulet can't find an accommodation with unions, the alliance could unravel by 1995.

Likewise, Chancellor Helmut Kohl's government, facing a series of elections next year, caved in to demands by the union-backed Social Democratic Party in October to hold off further market-opening measures that threaten DBP Telekom. In return, the government can sell off Telekom, which is \$60 billion in debt. But if the compromise forestalls the wrenching changes the operator needs to shape up, it could have brutal effects later in the decade—once the EC finally opens up the market (page 42).

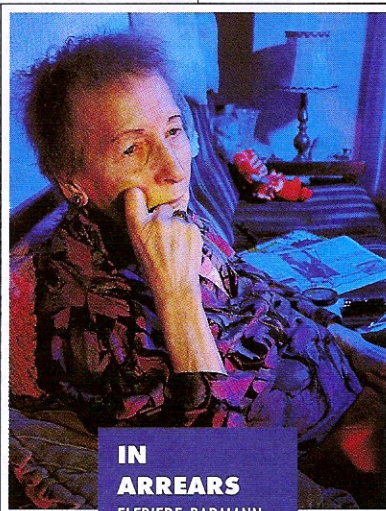
By then, competitive fires will be raging. A pack of aggressors has already shown many PTTs to be easy targets in an open market. Last year, for example, IBM, Sprint, AT&T, General Electric Information Services, and others collectively absorbed 34% of the \$3 billion high-growth market for data-transmission services, up from 23% in 1991, according to market researcher Ovum Ltd. In the process, many of these companies have been building networks of lines leased from the PTTs, getting ready for the day

when they can attack phone customers.

Abetted by the alliances of BT-MCI, Unisource, and the Franco-German tie-up, battles are already breaking out over contracts for corporations' inter-office phone and data networks. Cross-border corporate traffic, a \$3.5 billion market where tariffs are high, is especially vulnerable. "As much as 20% of some PTTs' profits are immediately under threat," says David Cleevely, managing director of Analysys. No wonder operators were unnerved earlier this year when AT&T announced plans to erect a \$350 million pan-European network for business calls. Sprint has already nabbed contracts to manage services for Unilever, Reuters, and others.

PTTs are fighting the drain of business by dropping international call charges—as much as 60% in the past two years. But rivals are prying open regulatory loopholes with increasing alacrity. Three-year-old Viatel Ltd. in New York, backed partly by moneyman George Soros, invested \$50 mil-

lion this year in a network to carry calls around Europe for companies such as Sanyo Electric Co. and Trans World Airlines Inc. It circumvents Europe's ban on public voice competition because users



IN ARREARS

ELFRIEDE BADMANN RECEIVED A BILL FOR \$10,000 FROM DBP TELEKOM FOR SIX MONTHS OF SERVICE

lion this year in a network to carry calls around Europe for companies such as Sanyo Electric Co. and Trans World Airlines Inc. It circumvents Europe's ban on public voice competition because users

are limited to client companies and their affiliates. And Sprint installed a phone switch in London this year through which companies such as SmithKline Beecham PLC send calls over leased lines from the Continent to the U.S. or back to Europe. Billed at low British rates, it's cheaper than dialing direct. "Europe is a table of dominoes waiting to fall," says Daniel Briere, president of Verona (N.J.) consultant TeleChoice Inc.

To survive, every Continental European PTT will have to embark on radical restructuring. For one thing, they'll need to make big investments to update services. Operators in France, Sweden, and the Netherlands have largely modern-

ized. But those of Germany, Italy, and Spain face big risks. All are heavily in debt and lag in installing cost-saving digital switches and fiber-optic cables. Italy's STET has lost more than 10% of its \$1.35 billion worth of international traffic to the likes of low-priced Viatel.

They'll also have to tackle distorted tariffs. For decades, they have subsidized local services by overcharging for long-distance—to the tune of \$18 billion across the EC last year. As these calls fall in price, callers are seeing local charges soar this year, with increases of from 39% in Italy to 400% in Ireland.

As operators wrestle with such perils, regulators must also strike a balance

among a bewildering set of interests. While safeguarding affordable services, they must promote measures that will push up local rates. And though they may be tempted to ease the pressure by postponing liberalization, they would do so at the risk of putting off hard decisions until it's too late. An open market won't come without pain. But the benefits it will bring to Europe's competitiveness, and even to consumers such as Frau Badmann, could more than make up for it.

By Jonathan B. Levine in Paris, with Gail E. Schares in Bonn, Julia Flynn and Paula Dwyer in London, John Rossant in Rome, and bureau reports

Commentary/by Gail E. Schares

GERMANY MAY BE DIALING ITSELF OUT OF THE MARKET

It was billed as the birth of a new European powerhouse. In grand style, French and German officials announced plans on Dec. 7 to merge data and other services of state phone companies France Telecom and Deutsche Bundespost Telekom. Between nibbles of caviar and paté in a penthouse suite in Brussels, executives insisted the megamerger would at last create a Eurogiant competitive in global markets against the likes of British Telecom, MCI, and AT&T.

Maybe. But Germany still lacks the will to truly open its markets. For starters, the opposition Social Democratic Party is threatening to torpedo the privatization of DBP Telekom, leaving it unable to raise new capital or restructure itself—much less swap stock with France Telecom.

CATASTROPHIC. And even if Parliament passes a privatization law early next year, it will be a half-hearted move. The government has already agreed to halt deregulation in exchange for the Social Democrats' support for privatization. The compromise would allow Telekom to rake in profits until 1998, when the European Community plans to throw open the markets once and for all.

While delaying deregulation buys time for Telekom, it could be catastrophic for German competitiveness. Telecommunications is one technology in which Germany still has a fighting chance in global markets. It has already lost out in computers, semiconductors, and biotechnology. If it waits



FAUSTIAN BARGAIN

A POLITICAL DEAL HAS SHIELDED DBP TELEKOM FROM DEREGULATION UNTIL 1998

to test itself in telecoms, it may find itself left in the dust again.

The danger signs are abundant. Consider E-Plus Mobilfunk, the second private mobile-communications company to be licensed. It has spent \$200 million on equipment for its new digital cellular network, and nearly every order went to foreign suppliers. "They gave us better offers on the cost side, and the technology is better," says Dietrich Gemmel, head of corporate development at E-Plus. German companies, he adds, "are still stuck in first-generation technology."

Rather than enhancing competition, the alliance with France Telecom will merely protect domestic markets. And if AT&T joins the venture, as is envisioned, the resulting behemoth would "dominate the world," reports George Schmitt, executive at private cellular operator Mannesmann Mobilfunk.

Nor will the telecom sector be the only loser in Germany's Faustian bargain. German industry will pay the price in higher costs, noncompetitive services, and laggard restructuring. "We are saving jobs in an old bureaucracy at the expense of new jobs in a more competitive environment," says Jurgen Müller, a senior economist at the United Nation's International Telecommunications Organization based in Geneva.

Government officials insist the compromise is the only way to win a pro-privatization vote before the 1994 national elections. No doubt. But Germany should be aiming

to accelerate, not brake deregulation. As soon as the necessary laws are in place, the government should speed the entry of new competitors, even before 1998. Instead of waiting passively for the inevitable, German politicians should lead the way to open competition.

Problem is, the politicians are reluctant to expose Telekom to revenue-losing deregulation on the brink of its planned stock market flotation in 1996. Telekom urgently needs the proceeds, expected to be as high as \$18 billion. And the longer it holds a monopoly in voice services, the higher a price it can command. But protection now is certain to have a much higher cost in competitiveness down the line.

Schares reports on German industry from Bonn.