Weekly Briefing

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TERMINATION CHARGE FOR MOBILE PHONE USERS

Following its review of the mobile markets, Oftel has concluded that mobile termination rates are substantially in excess of cost and there is little incentive on operators to reduce charges.

A peak rate national call over BT's network is currently 24 pence for three minutes, while the same call to a mobile network is 60 pence for three minutes, of which 39 pence is the termination charge.

Oftel has proposed charge caps on termination rates of RPI – 12 per cent over four years. The proposed caps on the mobile operators will protect consumers from paying too much for calling a mobile phone, allow operators to make a fair return and be an incentive to be more efficient.

SPECIAL FOCUS—THE TELECOMMUNICATIONS INDUSTRY

Oftel – the regulatory body for the UK Telecommunications industry, has just published the results of its comprehensive research into the size and structure of the market. Drawing on published and submitted financial and operational information from all the main industry players, the research provides a fascinating insight into one of the most significant and competitively complex industries in the UK. In this special weekly briefing article, we have drawn out the main findings of Oftel, particularly in relation to the changes in the competitive structure of the market and the impact on UK consumers.

There is also a series of web links to allow you to explore the key trends in this important industry in more detail.

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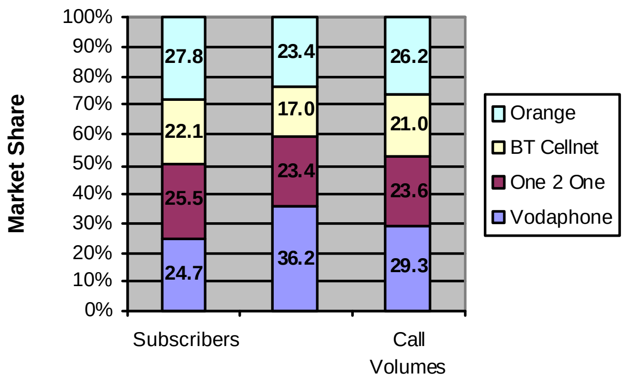

THE MOBILE GENERATION

By March 2001 there were 43 million mobile phone subscribers in the UK. The number of subscribers passed the number of fixed lines in October 2000. Oftel research in August 2001 showed that 73% of UK adults had a mobile telephone. Of these users, 70% now subscribe on a pre-pay package basis.

Increasing Market Contestability

During the year, **competition** increased in the mobile phone market. As shown in the chart above, Orange is now the largest operator in terms of subscribers. Competition also increased as a result of Virgin Mobile, the first Virtual Network Operator, achieving strong subscriber growth. The industry is clearly an **oligopoly**– characterised by periodic price wars but intensive non-price competition to deliver increased market share.

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A £41 Billion Industry and Growing Fast!

The Office of National Statistics (ONS) estimates that the turnover of the UK telecommunications industry was £41.4 billion in the year ended March 2001. This represents a 12% increase on the previous year. Oftel support this estimate based on its own findings. Of the overall total, some £20.4 billion of turnover was generated by British Telecom ("BT"), representing an overall market share (by value) of 49%.

Gross turnover is a relatively crude measure of the size of an industry as it does not properly take into account sales between industry players. ONS estimates that in 1999 the "value added" by the industry was £18 billion, or 2% of UK GDP

Fixed Lines – the Core of the Industry

"Fixed line" calls represent 40% of overall industry turnover. At March 2001, there were 35 million exchange line numbers in existence, one million higher than in 2000 due to growth in the number of business telephone numbers.

Call volumes from fixed telephones increased by 25% during 2001 driven almost entirely by huge growth in dial-up Internet usage following the introduction of unmetered tariffs. The rapid growth in mobile phone base also contributed to a 34% increase in fixed to mobile call volumes.

BT's share of the fixed line market (by volume and value) fell to 64-65%.

93% of UK homes have at least one fixed telephone line and of the remainder, some 6% are thought to use a mobile phone instead. 2001 saw an increase in the number of UK households and existing customers installing second lines, often for Internet and home-working use.

OFTELS PRICE CAPS

"Price controls strike a fair balance between the needs of consumers to be protected from high prices in this market and the ability of the operators to make fair returns"

Dave Edmonds, Director General of Oftel

Cable Companies Take An Increasing Market Share

The cable operators continued to increase their share of the residential fixed line market. By March 2001, 18% of all UK residential customers were directly connected to telephone services provided by cable operators, representing 25% of customers in areas where cable is installed.

Overall call volumes on residential fixed lines remained broadly stable. Oftel's research pointed to households increasingly using mobile phones instead of a fixed telephone and increasing Internet penetration – meaning that e-mail could be substituting for fixed line phone calls.

Falling Prices—Gains in Consumer Welfare?

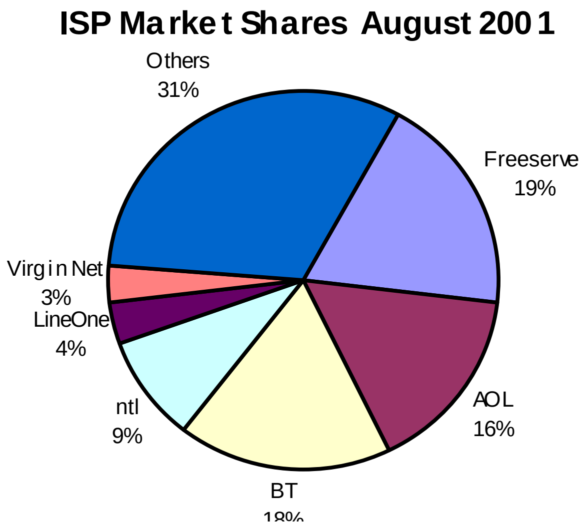
Oftel estimates that residential prices fell by 9% in the year to March 2001. its benchmarking work also shows that UK consumers continue to get a "reasonable deal" compared to other major economies. Oftel's data showed that residential phone prices in the UK were cheaper than in France, Germany and the US, although higher than in Sweden.

ACCESSING THE NET - PRE-PAY OR PERMANENT CONNECTIONS

The number of households opting for a permanent connection to the internet continues to rise at a fast rate– but in November 2001, 97% of connections to the net were through "dial-up" connections provided by ISPs. A permanent connection involves a higher fixed monthly cost – but this cost can be spread over many hours of use to bring down the average fixed cost of using the net

Source ONS

Mobile phone prices (measured on a "per minute" basis) have fallen for all networks except One 2 One who historically have **bundled** a lot of minutes with their monthly tariffs. Overall, the average price-per-minute fell by 15% in the year to March 2001. In real terms, this represents a fall in prices of nearly 17%. Oftel data shows that UK mobile prices are now slightly below average when compared to other major European competitor economies. But Oftel is convinced that prices can be lower and still give service providers an acceptable rate of return.



THE DIGITAL DIVIDE

The percentage of homes with access to the net from home computers has grown to 36% according to data released by the ONS in December 2001. But the level of net access depends strongly on income.

In the twelve months to the end of September 2001, less than 10% of households in the lowest two income decile had direct net access. This contrasts strongly with access rates of 65% for households in the 9th decile and 78% for the richest ten per cent of UK households.

Source: ONS

INTERNET SERVICE PROVIDERS– A CONTESTABLE MARKET?

During 2000/01 the UK Internet market continued to grow rapidly. The amount of Internet traffic continues to grow. During 2000/01 the total volume of Internet traffic originating on the fixed line network grew by over 200% to 92 billion minutes. Oftel expect that the increased take-up of always-on broadband services will see overall Internet call volumes rise strongly for the foreseeable future.

Increased competition amongst Internet Service Providers ("ISP's") has ensured that the UK has among the lowest prices in the world for dial-up Internet access, particularly for un-metered tariffs. The current market shares of UK-based ISP's are shown in the chart above. Freeserve– which entered the ISP market with such astounding success a few years ago has seen its share fall further to under 20%. It remains the market leader– just ahead of BT (18%) and AOL (16%).

Notice again the high level of market concentration among internet service providers despite the fact that entry barriers in the industry are relatively low. This gives the market a reasonable degree of market contestability– placing disciplines of firms to price competitively and improve the quality of service provision– not least the reliability and speed of net access and support services for net users. The three firm concentration ratio is 53%. NTL has gained market share as it has rolled out its internet service through digital television.

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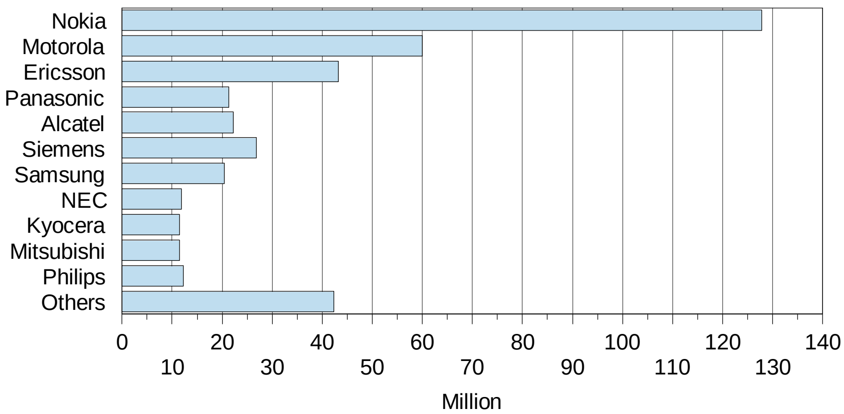
Oftel's Review of Mobile Phone Charges

In September 2001, Oftel introduced new price controls on termination charges for mobile phone service providers that covers the next four years. The price cap introduced is RPI-12% - meaning significant declines in both nominal and real phone prices between now and 2005. The falls in phone charges are expected to cut over £800m from phone costs over this period. The termination charge is paid by the network of the caller to the network of the receiver.

The price-cap regime might have been tougher on mobile phone companies but for the burden of debt telecoms companies have built up in the race to build third generation (3G) mobile phone networks. Consumer groups have long criticised mobile phone companies for basic charges that are well above the marginal cost to the supplier of making a call to a network. They have complained that mobile phone companies are exploiting their monopoly power leading to a loss of consumer welfare and a failure of the industry to achieve allocative efficiency

GLOBAL PRODUCTION OF HANDSETS (2000)

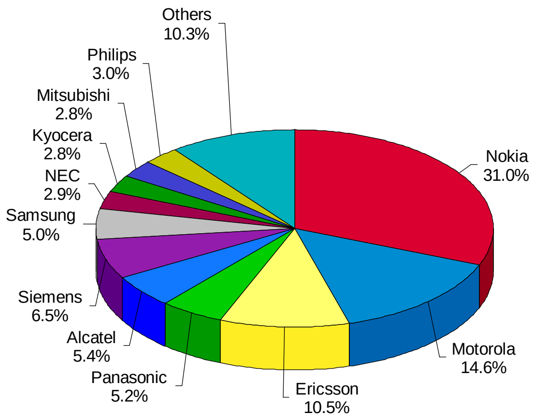


Difficult Times for Mobile Phone Producers

The world's largest mobile phone manufacturers are now facing up to a sharp fall in the global demand for mobile handsets. This recession is forcing many producers into a series of painful restructuring actions. Demand for new handsets in the European Union may have reached saturation point. And, the replacement demand for handsets has proved disappointing. In recent years, demand has been fuelled by the attractiveness of smaller handsets– but most mobile handsets are now as small as they are going to get.

Nokia is the market leader with a 31% market share in 2000. It has established a significant competitive advantage – preferring to maintain profit margins rather than offload handsets at heavily discounted prices as the global economy has suffered from a synchronised downturn.

GLOBAL MARKET SHARE FOR HANDSETS



Nokia overtook Motorola as the leading handset producer in 1998 and the US firm shows little sign of challenging Nokia's dominance at the moment. Nokia's market share rose to 35% in the first half of 2001 whilst Ericsson and Panasonic have both lost ground. Ericsson has responded by forming a joint venture with Sony. But the main changes in market share are likely to come from the second tier companies in the market. Samsung has set a target of a global market share of 7% in the next twelve months.