



FMC: Did We Miss It?

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Summary

Issue

Where are all these FMC services we keep hearing about, and how successful are they? It's too early to call, but would-be FMC providers should be aware of dark forces steadily eroding their opportunity.

Perspective

Fixed-mobile convergence (FMC) and fixed-mobile substitution are two warring forces. On the one side, fixed-line incumbents are looking to FMC to allow them to better leverage their in-house fixed and mobile assets, and offset dwindling fixed-line revenues. On the other, mobile operators are stepping up their substitution strategies to re-route more fixed traffic over their own mobile networks. FMC has not properly arrived in Europe, but mobile operators have been quick to see the writing on the wall, and spent much of 2005 building an arsenal of FMS services to offset its arrival. Driving substitution has become mobile operators' number one strategy against FMC, and the rate of innovation in this area in 2005 was extraordinary. For the purposes of this analysis, we've grouped substitution services into six categories: Homezone services, fixed alternative services, flat-rates, family tariffs and bundled, and in the business sector, mobile VPNs. All six are proving to be successful in degrees. Results, in the form of a higher mobile share of total market outgoing minutes, are likely to start trickling in by mid-2006.

Homezone Services: Let's clear up one urban myth immediately: So-called 'homezone' services are nothing to do with convergence. Persistent references to O2's Genion or Vodafone's Zu Hause as 'converged' are nothing but pure invention, and confusing to boot. A homezone service is an 'all-mobile' service in which all traffic, both voice and data, travels exclusively over the cellular network. The homezone service gives the user cheaper mobile calling rates (often marketed as 'fixed-line pricing' to communicate the cost-saving) for all calls made within the user's local GSM (or UMTS for data) cell. To complicate matters, homezone users are often provisioned with a fixed local-area prefix phone number that very much looks like a standard fixed-line number, and/or a phone that looks like a DECT phone, and callers-in are charged at fixed-line rates. Given all

this 'fixed' camouflage, it is hardly surprising that many homezone users in Germany today believe the service they use is, in fact, a bona fide fixed-mobile service. Furthermore, early homezone pioneers have evolved this proposition to 3G data, positioning 'homezone 3G' as a 'DSL alternative' for accessing the Internet, and some are even talking up 'mobile triple play' services (voice, Internet access and Mobile TV) – all done over cellular. No fixed-mobile handoff, no dual-mode handsets, no technological razzmatazz – and these services are selling well. O2 Germany launched its homezone Genion service in 1999, and its 3.2 million Genion users now represent 72% of O2's entire subscriber base. Furthermore, O2 credits Genion with its market-leading ARPU stature, and the operator is now using it to target small businesses.

Fixed-Alternative Services: Mobile tariffing has one or two distinct advantages over fixed-line pricing, and a few operators have been quick to take advantage of this. In Belgium, BASE recognized the monthly subscription charge of the leading fixed-line service in the market, Belgacom's Classic Line, as its Achilles' heel, and moved to take advantage of this with a highly aggressive service titled Economy Subscription. BASE created a marketing and pricing proposal that aimed to demonstrate that mobile telephony is, in fact, 'cheaper than a fixed line' (specifically, cheaper than Belgacom's Classic Line subscription). According to the operator, Economy Subscription met with a lukewarm response, and take-up to date has been unspectacular. BASE was unable to convince consumers to cut the cord in favour of Economy Subscription, and this service no longer has marketing priority. Another, much more devastatingly successful type of 'substitution' service has stolen the limelight – namely, the 'flat-rate.'

Flat-Rate Services:The arrival of 'the mobile flat-rate' was one of the most significant events in the mobile voice market in 2005 – and we can have 'no-frills' discount resellers and MVNOs to thank for these. Under pricing pressure from the discount sector, MNO tariff models underwent a radical transformation in anticipation of discount-led price wars. The driver for this innovation was the need to camouflage the raw price of a voice minute, and tariff development has led this concept to its logical conclusion: Flat-rate usage bundles. Early flat-rate offers took the form of options to existing subscriptions, or short-term promotions with 'fair-usage policy' limitations. To be fair, the truly unlimited flat rate (unlimited calling to all networks, fixed or mobile, at all times) does not yet exist in Europe, but the latest evolutions to emerge are getting closer and closer to this ideal. KPN Mobile has emerged as the real pioneer of the flat-rate model, and its BASE flat-rate in Germany and BASE Unlimited service in Belgium are re-defining European end-user expectations of mobile telephony. Despite an oddly confusing disparity in primary and secondary BASE branding in Belgium and Germany, respectively, the essential proposition of both services is similar. BASE Unlimited in Belgium offers unlimited on-net calling and SMS (i.e., unlimited mobile-to-mobile calls to other BASE or BASE secondary brands such as Simyo or Ay Yildiz) for EUR 25 per month, with additional charges for fixed or off-net mobile calling. In Germany, BASE (a secondary brand of E-Plus) offers unlimited on-net mobile and fixed calling, with additional charges for off-net calling and SMS. The flat-rate model is evolving, the 'fair usage policies' are being replaced with truly 'unlimited' offers, and the caveats (on-net, off-net, fixed-net) that represent the additional charges are disappearing. Incidentally,

the latest and most evolved of these flat-rate models, BASE Unlimited in Belgium, attracted 40,000 24-month subscribers in its first six weeks of launch.

Flat-Rate Service Evolution in 2005:

| Launch Date 2005 | Operator | Flat-Rate Offer | Caveats |
|------------------|------------------------|--|---|
| March | SFR (France) | Unlimited calling option to three designated SFR numbers with either Essential or Evolution subscriptions. | None – designated option model |
| May | Orange (France) | 3 numeros KDO: Unlimited calling to three Orange numbers for EUR 4 per month with all Orange forfait packages. | None – designated option model |
| May | Mobistar (Belgium) | Unlimited weekend calling promotion, 12-month contract for unlimited calling to fixed numbers only for EUR 15 per month. | Mobile calling not included |
| June | T-Mobile (Germany) | Flat-Rate Relax: EUR 10 per month, unlimited calling to fixed networks only within two STD code districts. | Mobile calling not included |
| August | E-Plus (Germany) | BASE flat-rate: EUR 25 per month, unlimited calls/SMS on-net mobile and fixed numbers. | Off-net mobile calls and SMS not included |
| September | T-Mobile (Netherlands) | Special Edition: Unlimited calling to fixed numbers with Relax 25, 45 or 75. | Mobile calling not included. Flat-rate limited to 150 minutes per day. |
| October | BASE Unlimited | EUR 25 per month, unlimited calling and SMS to on-net mobile numbers | Off-net mobile and fixed calls and SMS not included |
| | | | |

Family Tariffs: 2005 was the year that Family Tariffs started to gain traction in Europe, although their presence is patchy. Once again, substitution forms the driver for the family tariff phenomenon: the family tariff assumes that a high proportion of a user's regular fixed-line communication is to a select group of people, and aims to re-direct this traffic to cellular. Spain represents the most evolved market for family or group tariffs, and all three Spanish network operators now sport a highly diverse portfolio of services

offering discounted calls to designated mobile numbers, targeting couples, families and peer groups. But in the rest of Europe, such group tariffs have been slow to arrive. Isolated cases in other markets, such as KPN's Samen, have yet to be challenged, and most on-net discount marketing is still fashioned as 'options' to existing services (such as Orange France's 3 numeros KDO, listed above). But early evidence paints to a solid business case for such services. Movistar claims family or group tariffs were key to its growth rate in H1 2005.

| Service | Proposition | Number of subscribers by Q3 2005 |
|------------------------|--|----------------------------------|
| Movistar's Mi Favorito | Discount rates to one designated Movistar number | 3 million |
| Movistar's Mis Cinco | Discount rates to five designated Movistar numbers | 1.5 million |
| | | |

Bundled Services:Not content with substitution alone, many mobile operators are starting to look at the opportunity implicit in bundling services (mobile, fixed, DSL and other) together, reselling fixed and DSL through Carrier Pre-Select (CPS) and wholesale DSL for a more comprehensive proposition. In most cases, incumbents face regulatory restrictions in bundling together fixed and mobile services, but Tier 2 providers are proving more inventive. Mobistar in Belgium is a notable front-runner in the DSL space. The operator currently offers consumers a package of DSL with unlimited fixed telephony via CPS, and will be looking to add mobile to this package in 2006. Around 30% of Mobistar's customer base already takes mobile-fixed bundles. France Telecom is likely to be a front-runner in the bundled service model. Although the France Telecom NeXT strategy is essentially about convergence, the first step will be bundle-oriented, and early collaborations between Wanadoo and Orange, both in the UK and Netherlands, are testimony to this direction.

Mobile VPNs:Awarding businesses on-net savings (or even 'free' inter-colleague calling) is the lynchpin of the Mobile VPN proposition, as represented by key Mobile VPN solutions such as Vodafone's Wireless Office and Perfect Fit for Business, or O2's Mobex. In Europe, Wireless Office is perhaps the most prevalent and widely deployed solution, with over 1 million customers across nine markets. Although Mobile VPNs aim to encourage the enterprise to 'cut the cord,' few do so in reality, choosing instead to use these solutions side-by-side their standard fixed telephony service. To drive the substitution proposition harder in the larger enterprise sector, many mobile operators now market 'integrated' fixed-mobile services, allowing end users discounts on both mobile and fixed telephony by creation of a 'virtual' tunnel to the PSTN. Importantly, such solutions have the advantage of simulating an FMC experience with a comparable cost-saving proposition, without the requisite dual-mode handsets and hand-over technology investment implicit in the real thing.

And finally, Converged Services: Given all this success in the substitution space, it's tempting to suggest delayed FMC launches will face a deteriorated market opportunity. BT has now launched its consumer offering, but the promised end-year SME solution has yet to appear. It seems reasonable to suggest that the evolution of BT Fusion from Bluetooth to WLAN is holding things up, as are the lack of available handsets. Still, it now appears certain that UMA-based 'converged' fixed-to-mobile services will appear in 2006. Firstly, we expect to see the launch of BT Fusion for Business, but France Telecom, TeliaSonera and Telecom Italia will not be too far behind with their own respective products. Consumer services will probably appear first, with delayed business launches. UMA will continue to be the favoured FMC enabler in the short-term.

FMC Services Present, and Pipeline:

| Operator/ market | Solution | Features | Timing | Target market |
|------------------------|------------------------|-----------------|-------------------------------------|-----------------------|
| BT | BT Fusion (Bluephone) | Converged (UMA) | Launched Sept 2005 | Consumer |
| BT | BT Fusion for Business | Converged (UMA) | Expected end-year 2005 / early 2006 | SME |
| France Telecom/ Orange | 'Homezone' | Converged (UMA) | Expected in 2006 | Consumers |
| Telecom Italia/ TIM | 'Superphone' | Converged (UMA) | Expected in 2006 | Consumers, Businesses |
| TeliaSonera | Fixed-mobile service | Converged (UMA) | Commercial trials expected in 2006 | Consumers |
| | | | | |

In conclusion, FMC and FMS will continue to play each other off in the consumer space in 2006, with pros and cons on either side:

| Solution | Pros | Cons |
|----------|--|--|
| FMC | <ul style="list-style-type: none"> • Cost savings • One number • Ties a group of users into a single contract – loyalty benefits • Halts FMS | <ul style="list-style-type: none"> • Tied to specific, dual-mode handsets • Lack of cost-saving transparency • Customer 'new technology' education burden • One number – some prefer the convenience of two • Only available in one EU market today |
| Homezone | <ul style="list-style-type: none"> • Can be deployed with any handset • Gives 'the impression' of a fixed and mobile composite solution – comfort factor | <ul style="list-style-type: none"> • Only available in one EU market today • Evolving voice homezone services to voice and data (3G) creates cost disadvantage in |

| | | |
|----------------------|---|--|
| | <ul style="list-style-type: none"> • Ties a group of users into a single contract – loyalty benefits • Swift/easy deployment, low-tech maintenance for end user • Available today | relation to existing DSL alternative |
| Fixed-Alternative | <ul style="list-style-type: none"> • Clear FMS play, actively encourages users to ‘cut the cord’ | <ul style="list-style-type: none"> • Difficult to prove/communicate cost advantage • Goes against common presupposition of mobile’s premium • Unspectacular uptake record |
| Flat-Rate Mobile | <ul style="list-style-type: none"> • Clearly popular • Flexible model. Can be positioned as an ‘option,’ ‘promotion’ or ‘subscription.’ • Flexible pricing. The ‘flat rate’ can be communicated as unlimited calling/SMS on-net/off-net, to fixed numbers, or another combination of choices. • Strong FMS incentive • Strong proposition for users with predictable calling patterns, couples, etc. • Good answer to ‘no-frills’ discount pricing competition • Can be used with any device | <ul style="list-style-type: none"> • Open to abuse/over-use • No existing offers represent a ‘pure flat-rate’ proposition (i.e., unlimited calling/ SMS to all domestic networks) |
| Family/Group Tariffs | <ul style="list-style-type: none"> • Proving popular • Good loyalty generator, ties in couples/groups to long-term contracts • Flexible model, can be used as either a standalone service, or ‘option’ • Simple, easy-to-understand cost-saving proposition • Simple, low-tech deployment • Can be used with any device | <ul style="list-style-type: none"> • Low profile in Europe |
| Bundled Services | <ul style="list-style-type: none"> • Good pricing camouflage • Good loyalty driver • Highly flexible model • Allows mobile operators to diversify portfolio | <ul style="list-style-type: none"> • Regulatory restraints governing distinct service bundling in many markets • Indistinct cost-saving proposition |
| Mobile VPNs | <ul style="list-style-type: none"> • Flexible model, for SoHos, SMEs or larger corporates • Simple, low-tech deployment • Can be used with any device | <ul style="list-style-type: none"> • Potentially weaker cost-saving proposition in comparison with FMC |
| | | |

Recommended Actions

Vendor Actions

- Fixed operators with FMC ambitions should see mobile substitution strategies as a grave threat to their entire convergence proposition. Mobile operators are working to erode the supposition that mobile telephony is too expensive for ubiquitous use – and that is the raison d'être of FMC.
- Family tariffs have proven exceptionally successful in Spain. Any mobile operator looking for a new lead on substitution strategies should regard Movistar's success with its partner and group tariffs as a case study.
- Homezone services are relatively easy to deploy (no designated dual-mode phones, no wire-wireless transit hub), and are gaining ground in Germany. Homezone is a solid mobile operator response to FMC.
- Flat-rate mobile services are popular. Early case studies (see "BASE Cuts Off Flat-Rate Abusers, Creates The Perfect Controversy," December 1, 2005) point to a manageable incidence of customer abuse, or 'over-use.'
- The mobile flat-rate model isn't perfect yet, but it's getting there. Competitors in northern Europe or BeNeLux regions particularly should anticipate further evolutions of this high-profile tariff model.

User Actions

- End users attracted by a FMC proposition should be aware of handset choice limitations. In comparison, 'homezone' voice services are generally applicable with any GSM handset.
- New mobile data 'DSL alternative' services in western Europe will not be able to beat standard DSL pricing in the short- to mid-term. Fixed operators will still have the cheapest offers for broadband into the mid-term.

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