Ms. Rhonda Schnare
Office of General Counsel
Attn: Section 1377 Comments
Office of the United States Trade Representative
600 17th Street, NW., Washington, DC 20508

By e-mail to: fr0056@ustr.gov.

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Telecom Italia's commentary in the framework of the review by the Office of the United States Trade Representative of the status of compliance with international trade agreements, pursuant to Section 1377 of the Omnibus Trade and Competitiveness Act of 1988, 19 U.S.C. § 3106

Foreword

The following considerations by Telecom Italia are submitted as a commentary in the framework of the review by the Office of the United States Trade Representative ("USTR") of the status of compliance with international trade agreements, pursuant to Section 1377 of the Omnibus Trade and Competitiveness Act of 1988, 19 U.S.C. § 3106 ("Section 1377").

In particular, Telecom Italia commentary focuses on Italy's compliance with the provisions of the WTO General Agreement on Trade in Services.

Telecom Italia, and TIM, the Telecom Italia Group's company for mobile services, are ready to provide all further elements of analysis that may be needed by the USTR, and reserve their right to supplement the information provided hereby with significant developments that may appear.

A. Presentation of Telecom Italia and TIM

The Telecom Italia Group is ICT leader in Italy and, principally through the TIM mobile operator, a major player on the world stage. The Group responds to market challenges by leveraging technological innovation and focusing on the customer, cost control and operating efficiencies.

The main shareholder of Telecom Italia is Olivetti, a public traded company on Italian Stock Exchange, owning 54, 95% of its ordinary shares. Recently, before the end of 2002, the Ministry of Economy and Finance dismissed, through a public transaction, its 3,46% directly owned in Telecom Italia.

The Group currently supplies more than 27.1 million fixed-network lines and 24.6 million wireless lines in Italy (at 30 September 2002); Internet access unit Tin.it has almost 2 million active users (30 June 2002). TIM Group wireless lines outside Italy total 12.7 million (30 September 2002).

Telecom Italia's international operations are currently deployed in 19 countries in wireline and wireless telephony, Information Marketing and directories. The Group's focus is predominantly on wireless business, particularly in the Mediterranean Basin, in countries such as Greece and Turkey, and, in particular, in Latin America, where TIM has launched Brazil's first GSM market.

Telecom Italia closed its 2001 accounts with revenues of 30.8 billion euros (22.4 billion euros in the first three quarters of 2002) and EBITDA of 13.6 billion euros (10.4 billion euros in the first three quarters of 2002).

B. Commentary

Telecom Italia has submitted on January 14, 2003 its reply comments to the Federal Communications Commission ("FCC") in the Matter of International Settlements Policy Reform and International Settlement Rates, in the framework of the FCC's Notice of Proposed Rulemaking FCC 02-285.

In the light of the USTR's ongoing Section 1377 review, the present commentary was prepared by Telecom Italia to specifically extend to the Office of the United States Trade Representative some of the considerations presented to the FCC.

In particular, Telecom Italia commentary focuses on Italy's compliance with the provisions of the WTO General Agreement on Trade in Services.

1. Significance and consequences of the 1999 designation by the Italian Regulator, Autorità per le Garanzie nelle Comunicazioni ("AGCOM"), of TIM as a mobile operator having Significant Market Power ("SMP").

In September 1999, AGCOM notified (Order n. 197/99) TIM and Omnitel Pronto Italia as the only two Italian mobile operators with **Significant Market Power** in the national interconnection market. In November 2002, AGCOM confirmed the notification of the two operators (Order n. 350/02)

By European and Italian Law, this meant **imposing on these two SMP mobile operators the legal obligation of non discrimination and cost orientation**.

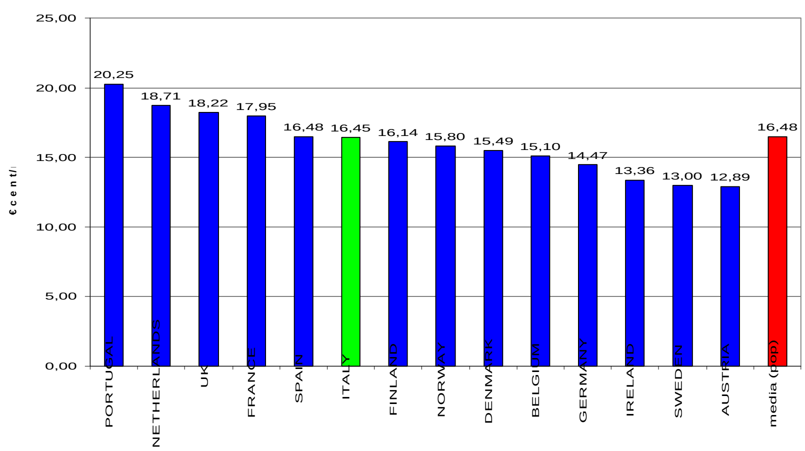
It should be noted that the Italian regulator has been one of the first European and world-wide NRAs to intervene in the matter of SMP notification of mobile operators in the interconnection market and consequently to use its powers to impose reductions of the termination rates.

Following the notification of TIM and Omnitel as SMP mobile operators in the Italian interconnection market, in December 1999 the Italian NRA (Decision 338/99) imposed a **25% reduction of their mobile termination prices**.

In this decision, in addition to imposing a maximum rate (18.59 €cents/min) for the weighted average Fixed-to-Mobile ("F/M") termination, the NRA also introduced **competitive mechanisms** with the objective of encouraging further reductions by the mobile operators of interconnection charges **through market competition**.

In fact, faced with competitive pressures, TIM gradually but significantly decreased its termination rates in 2001. With the further decrease that took place from August 2002, at an average level of 16.4 €cents/min, TIM's termination rates attained a level of **more than 11.5% below the maximum rate set by the NRA**, thus confirming a **market-dictated** steady trend of reduction in termination charges.

It is important to note that the reduction (since 1998 TIM reduced the average mobile termination rate of **more than 38%, not counting inflation**) is as much due to the NRA's intervention as it is a **consequence of market mechanisms**. Indeed, if one takes into account the inflation rate intervening in the same period, the overall reduction of termination prices from January 1999 is 47,6%. **Since the last regulatory intervention (December 1999) the effect of market competition alone accounted for a 6% annual reduction.** It should also be noted that such very significant reductions in termination rates took place notwithstanding Italy's specific geographic, orographic and population density distribution, which imposes **more difficult technical conditions on mobile networks than in other European countries. Nevertheless, Italy's termination rates are now aligned, and actually slightly below, the European average** (see figure 1).



F/M interconnection rates in the EU (Aug. 2002). The average value in the last column is the weighted average of the EU countries F/M termination rates, with a weighing factor equal to each country's population. The national data (OVUM Interconnect – August 2002) result from a traffic-weighted average of peak and off-peak rates.

2. Adoption of a LRIC-based accounting model

As noted above, the fact that AGCOM notified TIM and Omnitel Pronto Italia as the only two Italian mobile operators with **Significant Market Power** in the national interconnection market has meant, by European and Italian Law, **imposing on these two SMP mobile operators the legal obligation of non discrimination and cost orientation**.

Although the LRIC methodology has not been selected as the cost accounting methodology of choice at EU level, it must be noted that the Italian NRA is in fact leading a process to establish a cost accounting model, which is **carried out in full and open cooperaton between the NRA and the Dominant Market Power**

operators, and that is expected to generate an NRA Decision for the **implementation of a LRIC-based cost accounting model**.

In the year 2000, AGCOM started a proceeding in order to define the criteria for the cost accounting methodology of SMP mobile operators, which led to the NRA Decision 340/00/cons of June 2000 and to the December 2001 Decision 485/01/cons, by which AGCOM required the SMP mobile operators to use the FAC methodology based on Historical Cost Data for their year 2000 accounts. By the same Decision, the NRA also established a Working Group (including AGCOM,TIM and OMNITEL) to speed up the transition to LRIC by 2003, initially applying current costs.

The European commission's Eighth Implementation Report confirms this trend stating that: "For what concerns mobile termination, the NRAs have adopted a series of measures to regulate tariffs in line with the actual regulatory framework. In Austria the NRA has fixed mobile termination tariffs based on the principle of reasonable prices and on a cost accounting system. In some member states (Netherlands, Portugal and UK) the NRA has ordered a reduction in tariffs applied to mobile termination considering them too high and unreasonable, even in the absence of notification of mobile operators as having significant market power in the national interconnection market. In Finland three mobile have been ordered to bring their interconnection tariffs in line with their costs. In other member states, the NRA has imposed a reduction in mobile termination rates considering them a step towards the application of cost orientation, whereas in other countries (Belgium, Spain, France, Ireland, Italy, Sweden) the mobile operators have been designated as having significant market power in the national interconnection market and therefore are obliged to have cost oriented tariffs".

In connection with the possible adoption of the LRIC accounting methods, it has been by some non-European observer that the Italian fixed-to-mobile termination rates may be between 250 and 375% above LRIC cost model estimates. Telecom Italia comments that:

a. It appears difficult to interpret and analyze the above estimates, as their basis and construction methodology are not known to TIM, nor do they correspond to any exercise conducted so far by public agencies in Europe or Italy.

b. However, it must be noted that, quite to the contrary, in some cases the LRIC methodology may generate – at least temporarily – a cost path significantly higher than the current one[1].

c. Moreover, it is crucial that the mobile cost accounting procedures consider a weighted average cost of capital that properly accounts for investments such as in 3G networks and for the high level of risk that financial markets address to the mobile sector.

It must be noted that the liberalization process in Europe has been completed and is producing significant effects in terms of possibility of choice between operators and reduction of tariffs. **The prices for international calls have been reduced by over 40% since 1998 and in some countries by 65%[2].** Since liberalization, **there are more than 900 licensed operators in Europe**, representing a significant alternative to historical incumbent operators for the termination of international calls. A complete

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[1] In the UK, which has pursued with more energy the introduction of the LRIC model, it has been observed by OFTEL's Senior Economic Advisor that "the LRIC cost path is currently higher than the HCA cost path", the difference between LRIC and the Historical Cost model being estimated around 14% (Mr. Geoffry Meyers, 'The 30th Research Conference On Information, Communication And Internet Policy' September 30, 2002' (http://www.tprc.org/tprc02/agenda02.htm)

[2] European Commission 8th implementation report on the Implementation of the Telecommunications Regulatory Package (http://europa.eu.int/information_society/topics/telecoms/implementation/annual_report/8threport/index_en. htm)

and updated photograph of the status of liberalization in EU Member States can be found in the European Commission's 8th Report on the Implementation of the Telecommunications Regulatory Package.

In most countries with developed fixed communications infrastructure such as Europe, the cost of originating and terminating mobile calls has been higher with respect to the cost of transporting calls on the fixed network (as opposed to some developing countries in which the cost of mobile network is lower than the fixed network). This is reflected in the higher retail rates of calls from a mobile network with respect to the retail rates of calls from a fixed network. This is also reflected in the interconnection charges of terminating calls on a fixed network vs. the interconnection charges of terminating calls on a mobile network in countries with a "calling party pays" regime since the call reflects the underlying costs. There are a number of conceptual and analytic explanations for such a difference. Suffice it to say that **mobile network technological progress entails relentless investments to be made in order to cope with constant service upgrade across various mobile networks generation. As a consequence, economic cost estimates may be found higher than accounting costs, as documented by OFTEL**[3].

The average per minute fixed-to-mobile rate in Italy is about 16 Eurocents and it is expected to be reduced within the first half of 2003. This rate is applied as average mobile-to-mobile rate in full compliance with the existing rules which ensure non discrimination of termination conditions offered by SMP operators to international and national carriers;,

However it is important to note that this applies to countries, like Italy and other EU countries, where:

- there is a calling party pays regime;
- there is a liberalized telecommunications market both for fixed and mobile telecommunications;
- the competition dynamics between multiple mobile networks allow "customized" retailing to be part of the legitimate range of offers;
- the regulation in place ensures cost orientation or regulatory controls over interconnection tariffs of dominant and non dominant operators (both fixed and mobile). This is the case in Italy, where AGCOM has by Law overall visibility of retail offers and interconnection agreements between operators.

It must also be fully clarified that the level of prices of international calls to mobile phones is not only due to the price of the termination paid to the foreign mobile operator but also on the mark-up applied by the US carrier to its termination costs. US carriers apply a mark up of more than 10 US cents on international calls to Italy, as shown on the following table[4].

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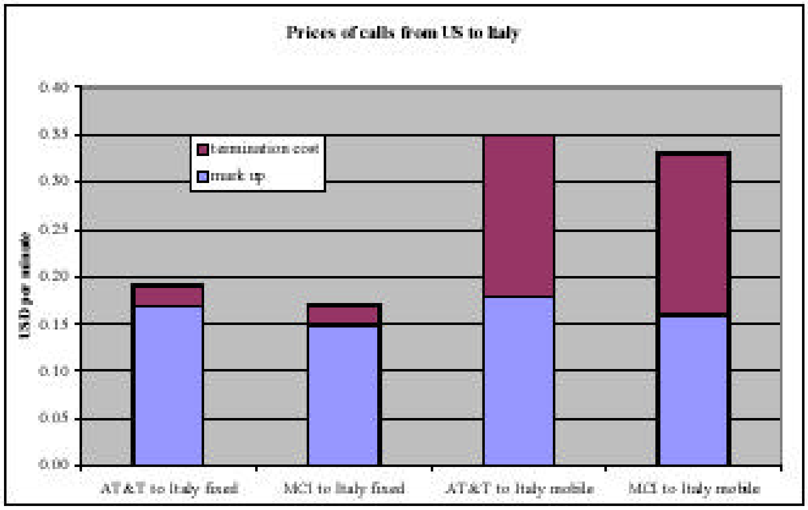
[3] Office of Telecommunications (2002), Accounting depreciation cost based estimates, letter to Competition Commission, 3 May 2002. Available at http://www.oftel.gov.uk/publications/mobile/ctm_2002/account_let0502.pdf

[4] Based on data for international calls published on www.att.com and www.mci.com. The prices include the monthly subscription of USD 2.99 for AT&T and USD 2.95 for MCI based on an assumption of 20 international calls per month per residential customer with average duration of 3 minutes.



In this light, we consider that **US consumers should be made more aware of the cost of calling an international mobile phone, since few US carriers adequately advertise this issue.** In many cases, on US carriers' website the cost of international calls to a specific country (i.e. Italy) which is shown is that of a call to the fixed network and only in a small footnote at the end of the page it is written that in some cases mobile termination surcharges apply.

3. Best practice

It has been estimated by some non-European observer that the Italian fixed-to-mobile termination rates may be 155% above the European best practice.

The "Best Practice" principle has no regulatory implication in the EU in connection with the termination market. Indeed, the EU position on this matter, often reiterated, is that the "Best Practice" form of comparative analysis must be abandoned and avoided for being methodologically incorrect and misleading in its results. Indeed, a valid international comparison may only be carried out between structurally and economically uniform situations.

However, as noted before, notwithstanding Italy's special geographic and orographic features and its peculiar population distribution, which impose **more difficult technical conditions on mobile networks than in other European countries**, Italy's termination rates are slightly below the European average.

Moreover, it is now expected that AGCOM may issue by mid-February 2003 a Decision to impose a further one-off reduction, followed by annual reductions of **at least 7-10% per year** over the 2003-2005 period by means of RPI-X cap.

4. The non-discrimination principle

Whatever the level of the charges involved, EU Regulation enforces a non-discrimination rule between interconnection rates for call termination that mobile carriers can charge regardless of whether the call is originated nationally or internationally.

Despite sensible differences among regulatory regimes in most of the considered countries, non discrimination of mobile termination charges among national and international services is granted everywhere, except in the case of serious influence exerted by macroeconomic effects (i.e. currency devaluation), as mandated by the GATS Agreement. The already recalled 8th Report recognizes that while much has been done, and much must still be accomplished to fully implement the European Framework, the non-discrimination record is clear for Europe, notwithstanding the fact that, understandably, some operators have raised the issue of discriminatory practice.

It should be noted that US international carriers and European international carriers are in the same bargaining position with regards to termination rates to be paid to mobile operators since, as previously said, no discrimination is possible between national and international interconnection. Furthermore is unlikely that European mobile operators may abuse of their dominant position, considering the reduction of the termination charges granted by mobile operators in the past years, following competitive pressure and regulatory interventions. In the event that a European operator would be considered to abuse its dominant position, the EU Commission must strictly monitor the situation.

Furthermore, noting that Section 1 (Competitive safeguards) of the WTO Reference Paper on basic telecommunications refers to anti-competitive practices such as "(a) engaging in anti-competitive cross-subsidization; (b) using information obtained from competitors with anti-competitive results; and (c) not making available to other services suppliers on a timely basis technical information about essential facilities and commercially relevant information which are necessary for them to provide services", it must be stressed that **neither the market (i.e. the 150-plus Italian fixed line operators) nor the Italian NRA nor the Italian Antitrust Watchdog Agency have ever raised against TIM any complaint for anti-competitive cross-subsidization practices, as recognized by the European Commission's 8th Report on the Implementation of the Telecommunications Regulatory Package.** The same applies in regard of point (b) and (c) above.

Moreover, noting that Section 2 (Interconnection) of the same WTO Reference Paper mandates for all signatory countries that "interconnection is to be ensured at any technically feasible point in the network: "(a) under non-discriminatory terms, conditions (including technical standards and specifications) and rates and of a quality no less favorable than that provided for its own like services or for like services of non-affiliated service suppliers or for its subsidiaries or other affiliates; (b) in a timely fashion, on terms, conditions (including technical standards and specifications) and cost-oriented rates that are transparent, reasonable, having regard to economic feasibility, and sufficiently unbundled so that the supplier need not pay for network components or facilities that it does not require for the service to be provided; and (c) upon request, at points in addition to the network termination points offered to the majority of users, subject to charges that reflect the cost of construction of necessary additional facilities", it must be remembered that when 19 operators filed In August 2000 a request with AGCOM to investigate the excessive fixed-to-mobile rates allegedly charged by Italy's mobile operators, the AGCOM investigation mandated by Law was closed **in January 2002, without AGCOM making any changes in the rate structure**.

As regards mobile rates, that must be "cost-oriented, transparent, reasonable and having regard to economic feasibility" it must also be noted that cost orientation is ensured by the above quoted NRA's Decisions 340/00/cons and 485/01/cons.

5. Role of the Italian Regulatory Agency

For the reasons stated above, Telecom Italia considers that not only AGCOM – which is by Law a public agency independent from the Italian Government - has so far carried out its mandate in full compliance of international trade agreements and of EU Directives, but also that the Italian market mechanisms have fully anchored TIM's termination rates to a very competitive environment.

It must also be noted that no proceedings has been launched in the EU or in Italy against TIM for its termination rates, underlining TIM's complete compliance with domestic and European laws and regulations.