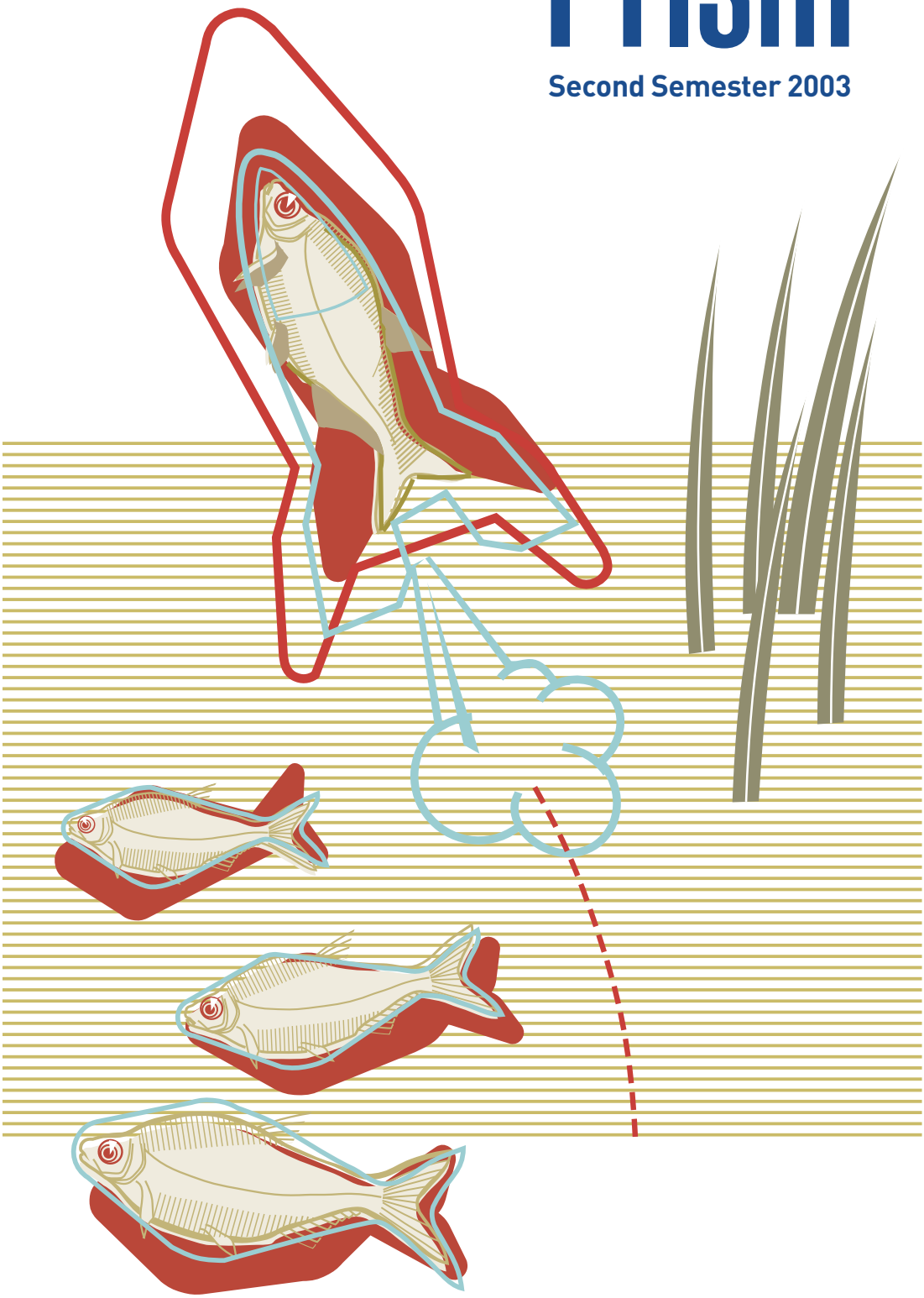
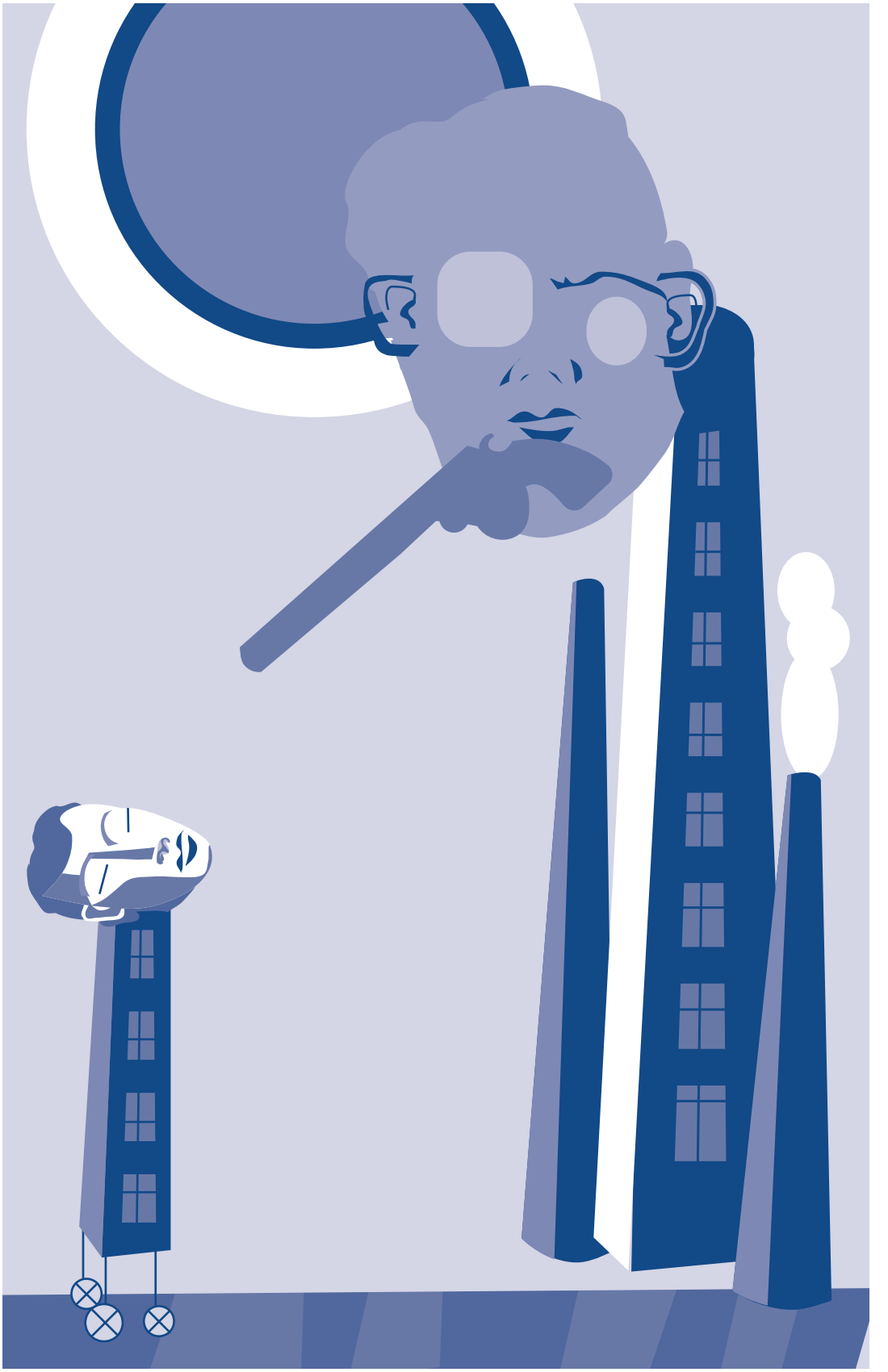
Prism

Second Semester 2003



Arthur D Little

Innovation at Work



Deregulation – David vs. Goliath revisited

Bruno Duarte, Jean Fisch, and Bernardo S. Sichel

This current paper focuses on the incumbent's view and studies some winning and losing strategies around the world in such deregulating industries as telecommunications, postal services, utilities and air transportation, among others. By analyzing the incumbent's strategies at home and abroad, the authors determine some overall rules to succeed in future rounds of liberalization around the globe.

"(The defeat of the invading Persian army) was a great moment in Greek history, perhaps the greatest, and Sparta and Athens had covered themselves in glory"[1].

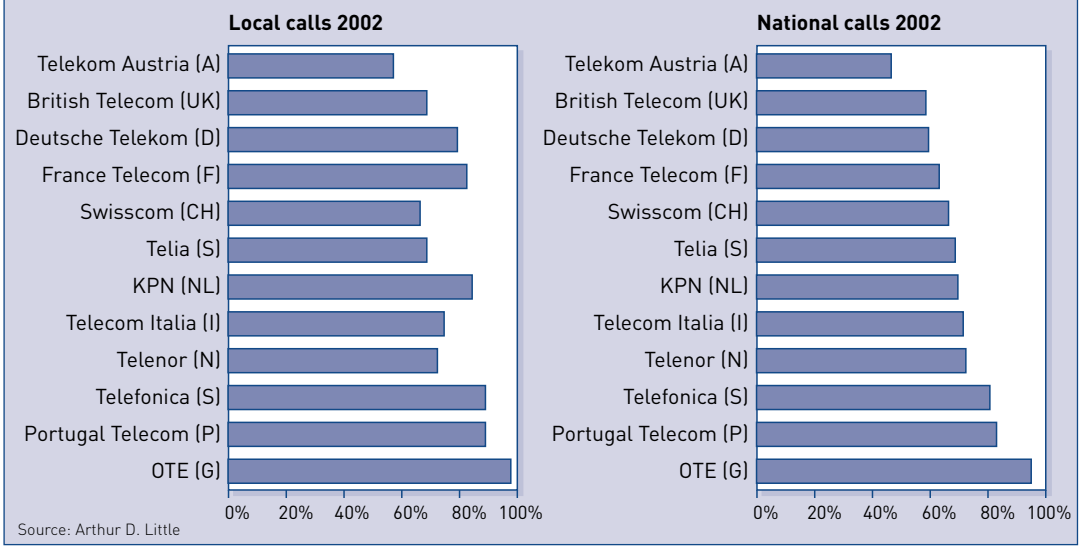
Liberalization brings about fundamental changes in the structure and dynamics of an industry. These changes are usually driven by an increased number of players and products available in liberalized markets. As a result, liberalizing markets theoretically provide vast opportunities for new players to take a stake of the business through conventional and/or disruptive business models.

In a first paper published in PRISM First Semester 2003, the authors analyzed the pitfalls and success factors for new players trying to enter into an incumbent's market. Now we turn our eyes to the incumbents. How have they fared in their liberalizing markets? On the whole not badly, actually. Despite the success of several new players in deregulated markets (e.g. Southwest in the 1980's in the U.S. airline industry and Tele2 in the 1990's in the European telecommunication industry), most incumbents have successfully been able to resist the anticipated invasion. For example, five years (and sometime even more for countries like the U.K.) after the liberalization of the European telecommunication markets, all incumbents still have market shares that would be the envy of any CEO in a competitive market (see exhibit 1).

Does that mean that preserving an incumbent's own turf is a no-brainer? Certainly not. Arthur D. Little's research and past work with incumbents show that their success must be qualified. Important differences in performance exist from one incumbent to another, as illustrated by the wide difference in stock performance of European telecommunication incumbents (see exhibit 2).

[1] Roberts, J.M. The Penguin history of the world. Penguin Books. Middlesex, England, 1990. P. 180. The Greeks thought that the Persians were going to come in millions so they strengthened the Peloponnesian League to contain them.

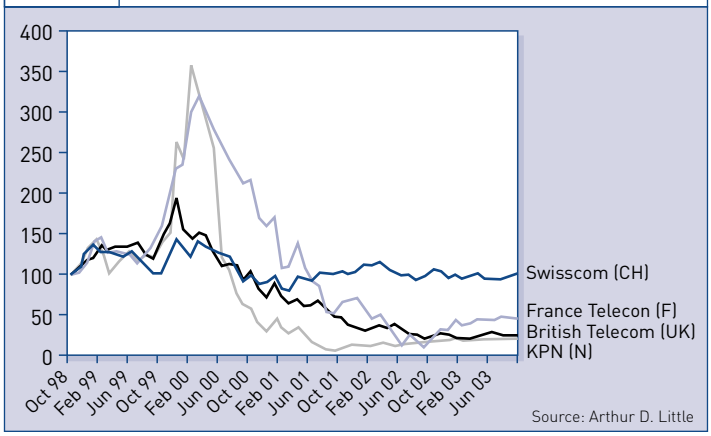
Exhibit 1 **European Telecom Incumbents' Market Share Fixed Telephony**



Source: Arthur D. Little

Such discrepancies in their efficiency are not only explained by local specificities such as market characteristics and the rigor of national regulation. Instead, we believe that they are the result of some successful and efficient strategies that have been used by incumbents in the past and that can serve as basis for incumbents facing newly liberalizing markets, such as postal services in

Exhibit 2 **Selected European Telecom Incumbents' Stock Price (Split and Dividend adjusted), Oct. 98 = 100)**



Source: Arthur D. Little

Europe, railways throughout the world, and utilities in gas and power markets. The focus of the present article is to characterize such strategies.

Competing Abroad or the Fallacy of the Market Share-Win-Back Logic

Before we center on the specific strategies to preserve an incumbent's home market, we would like to expand on what has been one of the largest and most costly mistakes of incumbents: an ill-conceived international strategy.

A number of incumbents went abroad in anticipation of the liberalization in their home market. Some invested in existing incumbents abroad, such as EDF, which has acquired in full or in part a number of electric utilities all over the world, or Swissair, which bought into the now bankrupt Belgian airline Sabena, or Deutsche Telekom, which, acquired stakes in Eastern European incumbent telecommunications operators. Others chose to set up new entrant operations essentially from scratch, as KPN or Telecom Italia, to enter respectively into the Belgian and French telecommunications markets.

Through the above actions it was hoped to regain abroad what would be lost at home. More specifically, incumbents believed international operations would create value by:

- Leveraging operational synergies,
- Generating additional revenues by better serving international customers,
- Hedging their bets in anticipation to their loss of market share at home.

To our knowledge, very few incumbents have been able to improve their operational performance through internationalization. Operational synergies are often anticipated, especially thanks to increased economies of scale and competency-transfer from the incumbent's domestic operations. However, few such synergies actually materialize. In network industries, such as telecommunications, railways, energy or postal services, international presence seldom translates into operational cost savings as most economies of scale tend to be at the regional or national level. In some sectors, international synergies do exist,

(e.g. in the power electricity sector, international synergies exist in theory in terms of improved portfolio management of their power assets) but they are limited due to technical as well as regulatory constraints (e.g. the technical and regulatory limitations on cross-border power transmission capacities).

Operational synergies are often anticipated, especially thanks to increased economies of scale and competency-transfer from the incumbent domestic operations. However, few such synergies actually materialize.

Moreover, potential savings have often been more than offset by the increased complexity of managing international organizations. This hampers experience-sharing as foreign subsidiaries eagerly try to keep their independence and avoid what is perceived as over-standardization imposed by the mother company. How often have we heard managers argue British customers were so different from Italians that it was necessary to develop a new marketing plan almost from scratch? Frustratingly, the same managers were eager to import some bad habits from their mother companies, such as vertical over-integration or bureaucratic and complex organization. Too often they were merely replicating the common mistake among new entrants who believe that a "me too" operation abroad will benefit from inherent cost advantages compared to the local incumbent's structural inefficiencies. As already demonstrated by Duarte and Fisch in the first part of this article, such a belief is a sure recipe for disaster. Such issues also tend to become even more important, since setting up ambitious ventures abroad can distract top management at a time when the core business at home is under attack.

However, operational leverage from international presence is possible. It is symptomatic that this has only been achieved by a few rare new entrants. "Not invented here" behavior is relentlessly fought in the European organizations of new entrants Tele2 and Ryanair, while standardization is scrupulously enforced. Within Tele2, one country will typically take the lead in experimenting a new tariff structure or a new marketing campaign. Once the test has proved successful, it is then extended to all other European operations[2] with extremely limited customization. This is achievable thanks to the informal network

[2] Tele2 operates in more than 20 European countries

woven within Tele2 thanks to frequent staff rotation. For example, the current marketing director in Belgium is French and was the former direct marketing director for Europe. The heads of Tele2 in Germany, Spain and Denmark are the former marketing directors for Italy, France and Sweden respectively. The head of billing in Spain was formerly based in Switzerland, etc.

The supposed necessity of a seamless global one-stop-shop product for international corporate customers can also be a major thrust behind foreign expansion. Tight control over the partner is often deemed mandatory in order to secure standard seamless processes and services. Therefore, capital links have often been set. However, this has proven too time-consuming and costly to be translated into a real competitive advantage. In many instances, looser partnerships such as commercial agreements would probably have been more efficient than the inflexible, bureaucratic and costly operations which often result from incumbents' acquisitions abroad.

Some incumbents believe that even without operational synergies or increased revenues from international customers, investing abroad still makes sense in order to limit their dependency from their threatened home market.

Some incumbents believe that even without operational synergies or increased revenues from international customers, investing abroad still makes sense in order to limit their dependency from their threatened home market. In some instances this led to significant value creation thanks to buy low and sell high opportunities. This is the case with Ameritech, which acquired a stake in Matav in 1993, increased its stake in 1998, and then sold it with a handsome profit to Deutsche Telekom in 2000. However, this can also be risky, as shown by Vivendi's adventures in Poland, where it recently sold its 49 percent stake in Elektrim Telekomunikacja for half of what it paid in 1999. In our view, such approaches should be appreciated from the angle of a private-equity investment in the context of a diversified financial portfolio management of excess funds, rather than from a business strategic point of view.

At the end of the day, numerous international ventures led by incumbents have turned sour. As a result, a number of these incumbents have retrenched back to their home operations, such as British Telecom, which sold off most of its foreign ventures and is now focused on its

domestic operations. Does it mean that these approaches do not make sense? Absolutely not. Value creation through investing in foreign operations can be dramatic. But it requires spotless execution both at strategic and operational levels that incumbents have often found difficult to deliver.

Competing at Home or Managing the New Entrant Success Zone

Incumbents must be ready to cannibalize their current products and services and dilute their earnings in the short term if they are to sustain the assaults of new entrants.

In any case, an incumbent's priority under the threat of liberalization should be to defend its home turf. In order to do so, incumbents must realize that maintaining the status quo is not an available option. They must be ready to cannibalize their current products and services and dilute their earnings in the short term if they are to sustain the assaults of new entrants.

The concept of available success zone for new entrants

To better understand the strategic option of cutting off competitors and the strategies that follow, it is useful to frame this challenge in terms of the "success zone" available to new entrants.

New entrants' strategic choices can be mapped according to two factors: price aggressiveness and differentiation[3]. New players cannot push these competitive levers to an extreme; in fact, there are at least three limitations to the possibilities available to new entrants that define the "success zone" accessible to them. These limitations derive from the customer requirements, the economics of the business and the innovations available in the short term.

Customer requirement limitation: This is the minimum demand from end-users regarding price and differentiation. The attributes of the incumbent existing offers directly influence customer expectations. Below a certain level of differentiation and above a certain price level (low

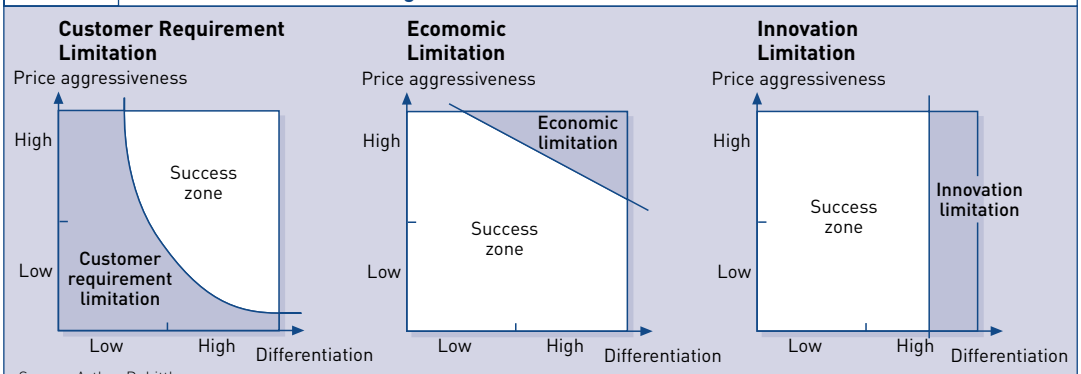
[3] This is a simplified framework since there are several other dimensions that could have been considered (i.e. geographical focus, target market, etc.). However, we have found that strategies developed through this simplified version are robust across other dimensions, allowing us to use this pragmatic version without compromising analytical rigor or obtaining biased results.

price aggressiveness), end-customers will not subscribe and the new entrant customer acquisition will be limited. The shape of the curve is due to the fact that the customer may be willing to accept a higher price as long as it is balanced by differentiating attributes.

Economic limitation: Price aggressiveness and differentiation are eventually limited by economic considerations, mainly profitability and funding requirements. After a certain point, the cost of differentiation (brand investments, retail deployment, etc) or aggressive prices (price reductions) surpasses the extra revenue generated. Ultimately the new entrant ability to improve the market economics, either by improving the market attractiveness or by operating an optimized business model, determines its leeway regarding the economic ceiling.

Innovation limitation: While innovation possibilities may be constrained by technological barriers, marketing is typically a fruitful area thanks to incumbents' lack of maturity in this field. New entrants may innovate on pricing packages, new distribution channels (e.g. Internet) and added value services, but then again differentiation possibilities are not infinite.

Exhibit 3 | Three Limitations Defining the New Entrant Success Zone

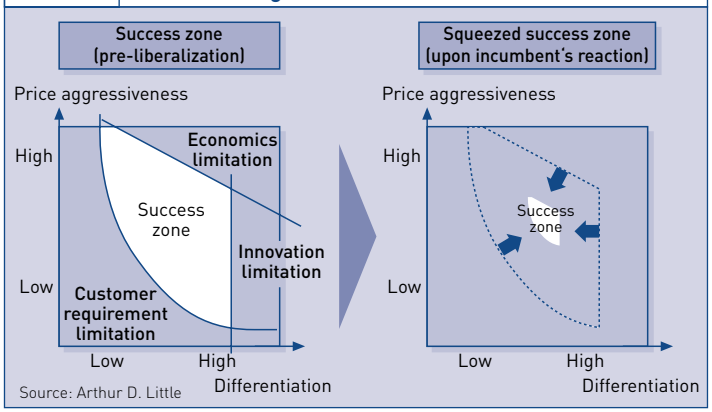


Source: Arthur D. Little

How to Manage the New Entrant Success Zone

In general, the larger the "success zone" the greater the new entrant's chance of success. Therefore, in order to deter potential competitors and block new players in the initial stages of deregulation, incumbents must focus on

Exhibit 4 How to Manage the New Entrant Success Zone



Source: Arthur D. Little

squeezing the perceived and/or actual attractiveness of the "success zone" available to new entrants while preserving the intrinsic profit potential of the market.

To do so we offer three effective strategies: engaging on active signaling, segmenting the market and reducing operating costs. In addition, we warn about a fourth strategy: making preemptive commitments which is appealing ex-ante but has proven ineffective ex-post.

- Engaging on active signaling

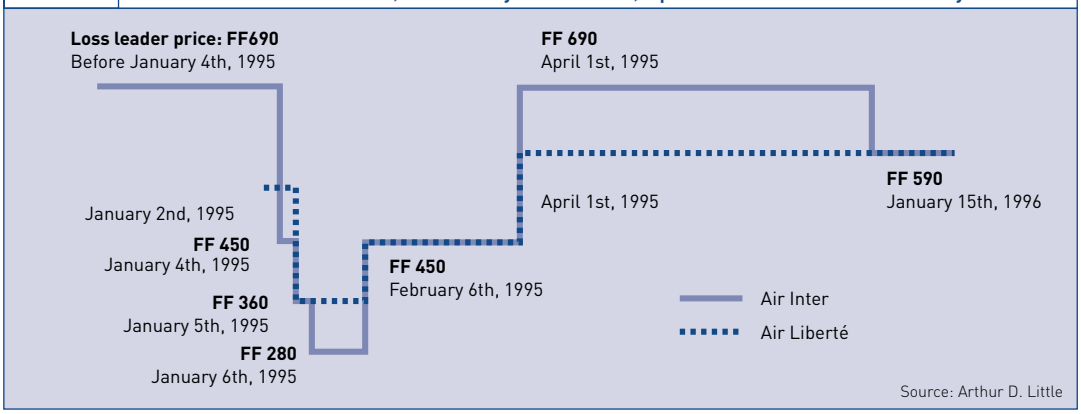
  Active signaling serves the purpose of changing the perceived attractiveness of the "success zone" without destroying much value in the market. If properly used, it achieves the dual objective of discouraging new participants and influencing regulators and customers. Active signaling includes both actions and announcements.

  On the action front, signaling is aimed at warning new players about the incumbent's intentions to protect their home turf, raising the barriers to new entrants and increasing the switching costs for current clients and customers. Novel pricing schemes, blocking brands, new distribution channel arrangements and supplier partnerships are strategic actions that support these objectives. An illustrative example is provided by the French incumbent domestic airline Air Inter's tit-for-tat

price reaction in response to Air Liberté's aggressive entry price to the French market. Air Inter did not hesitate to follow suit and even undercut Air Liberté, so as to demonstrate the company's willingness to leave no leeway for Air Liberté to position itself on prices. While promotional return fares on the Paris-Toulouse route (among the Top three French domestic routes in terms of traffic) decreased by almost 60 percent in the aftermath of Air Liberté's entry, they eventually increased to a "reasonable" level, less than 15 percent below Air Inter's pre-liberalization prices.

On the announcement front, threats and promises are aimed respectively at warning new entrants about the incumbent's intention to protect their home turf and gaining support from regulators and trust and loyalty from clients. An illustrative example of the latter is provided by the opportunistic response of many utility

Exhibit 5 | Promotional Return Fair, Paris/Orly - Toulouse, upon Air Liberté Market Entry



Source: Arthur D. Little

companies during the recent blackout in the northeastern United States in August 2003. Leveraging on the effects that the blackout had on millions of citizens and the regional economy, some incumbent electric utility companies stated that since all U.S. states affected by the blackout had initiated retail competition in their markets, the deregulation process in this sector should be revised. While the effect that the blackout and the ensuing lobbying efforts made by the northeast utility companies will have over U.S. regula-

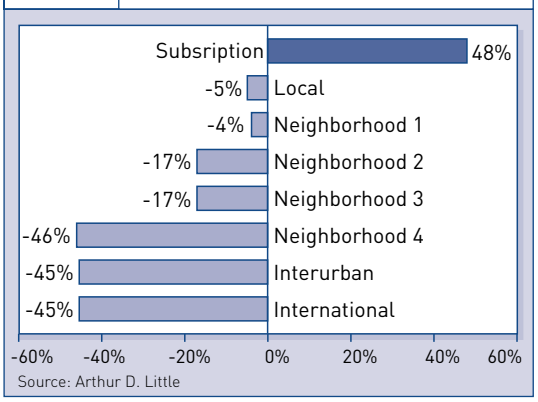
tion is still uncertain, some analysts already predict that Ontario (Canada) will abandon or delay its electricity deregulation process[4].

- Segmenting the market

Segmenting the market serves the purpose of changing the actual attractiveness of the "success zone" by creating several playing fields. This in turn allows the incumbent to increase the overall economic limitation for new players, initially control the price-differentiation tradeoff in several markets and limit the impact of possible disruptive innovations while preserving much of the profit potential of the overall market.

In strategic terms, segmentation achieves the objective of covering against flank attacks that could be used by competitors to develop the resources and capabilities to attack core markets in the future. The network industries (where cross-subsidization between customer segments is common before the liberalization process) provide an illustrative example. By rebalancing their prices before the market opens up to competition, incumbents have been able to reduce the attractiveness of vulnerable segments while protecting their core. A case in point is France Telecom, which was able to increase its prices in fixed telephony between 1996 and 1999 (48 percent in residential and 73 percent in business), while reducing its prices in long-distance and international calls (approximately 45 percent) so as to limit its overall market share losses.

Exhibit 6 France Telecom Price Evolution in France - Residential Fixed Voice Telephony, 1996-99



Source: Arthur D. Little

Segmenting is an effective weapon to develop selective and targeted responses to new entrants who follow skimming strategies, e.g. focus on the most profitable segments while the incumbent is forced by the regulator, for the sake of universal service to keep serving unprof-

[4] Taken from "Lights out: lessons from the blackout". Knowledge@Wharton (August 27 to September 9 edition).

itable segments. In the liberalizing postal services market, new entrants are focusing on the profitable business mail segment while leaving the incumbent operator to deliver mail in remote regions.

Though segmentation divides the market and forces new players to decide where to compete, special attention should still be given to the most attractive markets.

Though segmentation divides the market and forces new players to decide where to compete, special attention should still be given to the most attractive markets to avoid underinvesting in them and opening up an opportunity for the competition. The U.S. airline industry provides an illustrative example. The United States Airline Deregulation Act of 1978 allowed large carriers to create their hub and spoke networks. While this enabled the established carriers to achieve important efficiencies, it also opened the door for low-cost players like Southwest Airlines to focus on underserved small markets with an alternative point-to-point business model. After becoming the most profitable airline in the U.S. business, Southwest Airlines is now expanding into larger and more profitable markets with a healthier balance sheet than its peers. In turn, established players like Delta are responding with new ventures (i.e. Delta's Song) that serve smaller cities with a point-to-point model, but by now these markets are more heavily contested[6].

- Reducing operating costs

  Reducing operating costs serves the purpose of changing the actual attractiveness of the "success zone" by increasing the economic limitation in the market. By becoming leaner, incumbents are able to price their products and services at price points that cannot be readily matched by new players, thus discouraging many from entering the market. Furthermore, it provides the incumbents with enough cash to respond to the assault of those players who decide to enter the market and also to invest in new growth opportunities in other products and services. When done effectively incumbents can significantly improve their operating cost position. This was the case with many European

6 Dann, Jeremy. Multiple disruptions on the radar screen.

telecom incumbents in the second half of the 1990s who have improved their headcount productivity often by 40 percent or more.

Several routes can be followed to reduce operating costs. They range from headcount reduction, recruitment stop, direct cost-reduction programs, re-engineering programs to more structural changes, including outsourcing or setting up one's own low-cost operation. All these approaches are very effective, but need to be used wisely. Cost reduction efforts put organizations under pressure; it is therefore vital that mechanisms are in place to ensure that the cost reduction remains effective structurally.

- The need for sustainability of cost-reduction measures, especially on direct cash expenses, but also on HR reduction, is often under-estimated. A telecommunications player in Europe provides an illustrative example. After a strict HR reduction program, the company found its cost base wasn't decreasing, but rather increasing: it turned out that the headcount reduction wasn't framed into an organizational and procedural redesign. The result was an increase in temporary staff, body-shoppers and outsourced contracts.

- Many incumbents have gone the route of outsourcing part of their non-core operation to subcontractors. This strategic action can be very effective, but needs to be handled carefully. Broadly speaking, the golden rule is "don't outsource your problems". An incumbent facing difficulties reducing the headcount in its payroll department provides an illustrative example. After outsourcing the payroll activity, it found itself with a cost increase of more than 50 percent (plus the reconversion cost for the part of its payroll staff that was not taken over by the outsourcer). Further analysis revealed that the overstaffing was the result of inadequate links between the payroll and the other systems in the organization. By outsourcing the operation, the problems and its hidden costs did not go away.

More drastic approaches have also been considered in some industries, as some incumbents tried to set up their own internal low-cost operations. Beyond fighting low-cost new entrants with low fare offers, the aim has often been to learn from what was regarded as an internal lab, so as to leverage this experience within the mother company operations. Such attempts have experienced countless difficulties. This is best seen in the airline business, where numerous airlines tried to set up their own internal low-cost operations, but have failed in their efforts. Classic examples include United Shuttle, US Airways' Metrojet, Continental Lite, or Delta Express in the United States, and KLM's Buzz in Europe. One of the key reasons for this failure is the difficulty of these low-cost operators to break away from the parent company's "genetic" heritage. As once put by Leo Mullin, the CEO of Delta Airlines: "the child of a dinosaur will always be a dinosaur".

Low cost operations should also clearly be positioned in terms of branding and possibly distribution to avoid any "contamination" with the parent company.

Another key reason for failure of setting up one's own low-cost operation is the risk of cannibalization. One should not mix up low cost and low fare. Low cost operations should also clearly be positioned in terms of branding and possibly distribution to avoid any "contamination" with the parent company. Still, setting up internal low-cost operations can work, as illustrated by the success of the Formule 1 low-cost hotel chain set up by ACCOR, the European leader in the hotel business, or the low cost airline GO, which was set up by British Airways and then sold to Ryanair as its mother company could no longer afford to fund its strong growth.

- Making preemptive commitments

Besides these effective strategies, we would like to caution against a widely used strategy, namely making preemptive commitments for incumbents in liberalizing markets. Although looking attractive ex-ante, experience shows that it is usually costly and highly risky given market and regulatory uncertainties.

In theory, commitments would achieve the objective of reducing the incentive for new participants to enter

the market by limiting their ability to gain sizeable profits. Following this logic, incumbents should be ready to defend their market share by investing up to the point at which the marginal return on investment becomes negative. Large and visible commitments would serve as an effective medium to signal this intention to potential competitors before value is destroyed in the market.

In practice, however, competitive advantages are seldom achieved and flexibility is greatly compromised due to the uncertainty still present in the market and the several limitations caused by the regulator who is seeking a more competitive playing field. A case in point is offered by some incumbent telecom carriers in Latin America who heavily invested in their networks prior to the deregulation process only to find the regulator body fixing the transfer prices at levels that completely eliminated the advantage of having developed the network. In contrast, a vivid example is provided by some utilities in the northeastern United States who decided to follow the opposite strategy by reducing their investments in high-voltage transmission lines to limit the possibilities of "merchant" generators undercutting them in their markets.

Insights for the Executive:

Inherently, incumbents in any industry, face the same problem: they know they will lose market share in their current market. There is only one way to go when you have 100 percent market share, and that is down. This problem can be exacerbated in some industries where the liberalizing market as a whole is maturing or even declining (e.g. letter mail in the postal services).

Our research clearly shows that winning business strategies follow the unmistaken logic of business value creation.

Abroad:

- Rule #1: Do not heavily invest abroad for the sake of diversifying your customer base.
- Rule #2: If you must break Rule #1, think twice about

the reality of your business model and take extreme care in the planning and execution process of commercial and operational synergies upon which you are banking.

At Home:

- Rule #1: Reduce potential new entrants' perceived success zone so as to deter new entrants.
- Rule #2: For those new entrants which were not detered, selectively squeeze their actual success zone.

Most of the above rules may appear to be just common business sense, and indeed they often are. But it is surprising that billions of dollars have been wasted by companies that did not stick to these basics of competitive strategy. In the end, liberalizing markets do provide vast opportunities for new players to take a stake of the incumbent's business, but as Sparta and Athens showed the world more than two thousand years ago, great victories can still be achieved by systematically and relentlessly preparing to confront the invading armies.

Bruno Duarte
... is an Associate Director at Arthur D. Little in France. He works on strategic and regulatory issues in liberalizing markets. His clients include major players and new entrants in the telecommunications, broadcasting, transportation and energy industries across Europe. He lectures in applied business strategy at leading French universities. Duarte holds an engineering degree in electronics from Supelec (France) and an MBA from INSEAD.

Jean Fisch
... is a Director at Arthur D. Little in the Benelux. He has helped many incumbents and new entrants develop and implement winning business strategies in liberalizing markets. Fisch focuses on telecommunications, electricity and gas industries. He holds a PhD. in physics from the University of Brussels and an MBA from the University of Leuven.

Bernardo S. Sichel
... is a Manager at Arthur D. Little Venezuela. His main area of interest is strategy development in highly uncertain environments. He has consulted for several local, regional and multinational companies in Latin America, including some new players entering to deregulating markets. Sichel holds an MBA from the Harvard Business School and worked for Procter & Gamble before joining the firm.