

The economic environment.

Positive development in 2010 // Momentum to slow slightly in 2011

Global economic development.

The recovery of the global economy continued in 2010 thanks to the acceleration in global trade and the expansionary monetary and fiscal policy of leading economic nations. According to a forecast by the OECD, the global economy may have grown by 4.5 percent in 2010 after contracting by 1 percent in 2009. Global economic output increased much faster than forecast a year ago, particularly in the first half of 2010. Yet, the pace of this recovery slowed slightly toward the end of 2010 when a number of economic stimulus packages came to an end in the industrialized countries and the resulting "push effects" weakened. This trend was not compensated completely by self-supporting growth.

The growth engines in 2010 were the emerging economies, which accounted for around 70 percent of growth worldwide. According to OECD forecasts and initial estimates, the economic upturn was perceptibly weaker and increasingly disparate in the majority of industrialized nations: Germany, the driver of the EU economy, recorded growth of 3.6 percent in the reporting year, outstripping the euro zone countries with their 1.7-percent growth. After starting the year on a strong note, the U.S. economy posted subdued growth. Viewed from a historical perspective, the growth rate of 2.8 percent was rather moderate. The core countries in our Europe operating segment also presented an uneven picture. Poland, Slovakia, and the Czech Republic show fairly good growth rates of 2.5 to 4.5 percent, whereas the economies of Greece, Romania, and Croatia contracted by between 2 and 4 percent year-on-year. The Netherlands, Austria, and Hungary recorded moderate growth rates of 1 to 2 percent.

Conditions on the labor markets also diverged considerably during 2010. Germany recorded a very positive trend in its labor market, due in particular to a flexible labor market policy in the form of reduced working hours, but also to a return to a healthy level of exports. Unemployment fell to 7.2 percent at the end of the year. However, in many other Western industrialized nations and core countries of Deutsche Telekom, unemployment is still close to the record levels seen in 2009 during the crisis. In the United States, the unemployment rate remained high at 9.4 percent. Countries with substantial national debt that have introduced austerity programs and fiscal policy measures are in a particularly dire macroeconomic situation, coupled with even higher unemployment.

Telecommunications market.

Our business in the reporting year was impacted by strong competition, intensified regulatory intervention, and the resulting price erosion.

The upswing in the global economy and the slight increase in consumer demand in most of our core markets were able to support the business environment only to a limited extent and were not a major source of impetus. A negative or continuous braking effect was apparent in countries where purchasing power is still falling. As a result of the high pressure on individual countries to consolidate their public finances, some of them raised existing or imposed new taxes on telecommunications companies in 2010. This had a negative impact on both consumption and on the telecommunications companies. In telecommunications, the economic crisis will continue to impact the markets in Southern and Eastern Europe in 2011. In some countries, governments will endeavor to improve the financial situation through fiscal policy intervention.

Germany.

Total revenue from telecommunications services in Germany decreased by more than 1 percent in 2010 to approximately EUR 61 billion. Fixed-network revenue was down 3.5 percent in this period compared with the previous year. Mobile communications business partially compensated for this decrease with a slight revenue increase of 0.8 percent.

In the reporting year, prices for (fixed-network and mobile) telecommunications services overall declined 2.0 percent year-on-year. Prices for fixed-network and Internet services declined by 1.8 percent, while prices for mobile voice and data connections were down 2.8 percent.

Germany's fixed-network market continued to be subject to major changes in 2010. Over 90 percent of voice minutes were covered by complete packages, while the share of voice minutes attributable to call-by-call and preselection declined further. The number of fixed-only lines remained approximately the same, while the number of fixed-network broadband lines in Germany increased by around 1.3 million to just under 26 million. Cable operators are the main beneficiaries in this situation, since they can offer high bandwidths, sometimes of up to 128 Mbit/s, as well as integrated products (telephony, Internet, and TV). In terms of user figures, cable companies posted growth rates of approximately 26 percent in 2010.

The expansion of the fiber-optic network is becoming more and more important for Germany. We are contributing to this build-out in Dresden, Hennigsdorf and Braunschweig, for example, where we have started laying fiber right into the homes of our customers.

Despite intense and predatory competition, the mobile communications market in Germany saw a slight growth in 2010. Regulatory decisions like the one to lower termination charges will play an increasingly important role in the development of the market. This is the reason mobile communications providers are placing greater emphasis on customer loyalty and value-driven growth among contract customers. Service revenues in the overall market grew year-on-year in 2010. This is mainly due to mobile data growth, which is a result of the ever increasing popularity of smartphones. To meet the rising demands in the mobile network, Germany already has 69,258 cell sites (source: Federal Network Agency), of which Deutsche Telekom alone operates around 25,000.

The new LTE frequency was auctioned in May 2010. Since then, telecommunications providers across Germany have begun to roll out the new mobile communication standard. We started doing this in June 2010, rolling out LTE in Brandenburg, Lower Saxony, Baden-Württemberg, and Bavaria.

Telecommunications companies continue to extend the range of products and services they offer to their customers. We, too, are entering into new areas of business, including automatic machine-to-machine data exchange, intelligent network structures and new service offerings for electronic data transfer, such as De-Mail.

Europe.

The telecommunications markets in the countries of our Europe operating segment were also dominated by intense competition, which put further pressure on retail prices. In addition, revenues were negatively impacted by the reduction in termination charges imposed by regulatory authorities. Telecommunications companies in most of the Southern and Eastern European countries assigned to the Europe operating segment were strongly impacted by government and regulatory decisions.

Even though the mobile communications markets in our Europe operating segment are largely saturated, market penetration increased in nearly all countries. The only markets where it decreased were Greece and the Netherlands. In the case of Greece, this was due to a new national regulation requiring prepay customers to be registered immediately. In the Netherlands, market penetration was lower because T-Mobile Netherlands deregistered inactive prepay customers.

The traditional fixed-network business is increasingly being pushed into the background. Further line losses were registered in all countries in the Europe operating segment in 2010, though the decline was slightly less marked than in the previous year. The broadband business, on the other hand, is still growing, albeit at a slower pace in 2010. Broadband coverage varies from country to country. The need for greater bandwidth continues to grow on the strength of business areas such as IPTV.

United States.

The U.S. wireless market as a whole continues to expand, as growth in data revenues more than offsets declines in voice revenues. The market is divided into four national operators (AT&T Wireless, Verizon Wireless, Sprint, and T-Mobile USA) and several regional operators. In addition to the network operators, there are a number of mobile virtual network operators (MVNOs) that are using the networks of one or several of the four national operators. The two largest operators, AT&T Wireless and Verizon Wireless, have achieved especially strong revenue growth and healthy margins in 2010. This was driven by strong growth in smartphone adoption and rising post-paid ARPU. Due to potential advantages through size, scale and their ability to bundle wireless service with other non-wireless communication services, AT&T Wireless and Verizon Wireless could be able to deliver services in a more cost-efficient manner and disproportionately increase their customer base, thereby negatively affecting T-Mobile USA's competitive position.

AT&T has had a competitive advantage in the past three years with the exclusive distribution of the Apple iPhone. However, this exclusivity will end in 2011 and distribution will be expanded to include Verizon, giving Verizon a similar competitive advantage. It is not clear yet at which point T-Mobile USA might get the iPhone. Verizon and AT&T, in particular, achieved proportionately higher net customer additions in 2010, which, combined with pressure from the regional unlimited discount operators, resulted in a slight decline in T-Mobile USA's market share in 2010.

A major theme for the industry is the deployment of 4G networks. Thus Verizon Wireless started the roll-out of LTE with a coverage of 110 million of the population reached by year-end. To date Verizon Wireless is offering only LTE dongles but plans to introduce LTE smartphones in 2011. AT&T and T-Mobile USA have deployed HSPA+ networks. As of year-end 2010 T-Mobile USA achieved an HSPA+ coverage of 200 million of the population. AT&T, which is believed to be behind T-Mobile USA in HSPA+ coverage due to a less advanced roll-out of fiber backhaul, has announced that it will begin deploying LTE in 2011. Sprint does not have its own 4G network but is relying on Clearwire, in which it has a non-controlling stake. As of year-end 2010 the Clearwire network, which is based on WiMAX, covered approximately 110 million of the population. Sprint has begun offering several WiMAX-capable smartphones.

Systems Solutions.

Whereas 2008 and 2009 were marked by the global economic crisis, 2010 showed clear signs of recovery. Despite the general market recovery, companies remained under pressure to reduce their costs. Many companies were hesitant to implement the necessary modernization and upgrading of their IT. Project and infrastructure business recovered slowly. This trend impacted the individual segments of the market in very different ways.

Economic recovery had little effect on the telecommunications business, a market that experienced intense competition and severe price erosion, as in previous years.

The market for IT services began to grow again following the crisis years and the recovery in outsourcing business in the area of Computing and Desktop Services (CDS) is tangible. This is not only due to the traditional outsourcing business, but also as a result of the success of cloud services, i.e., the provision of IT services over the Internet.

IT project business also recorded a slight growth in 2010 following a strong decline in 2009. Industry-specific systems integration business, driven by IT projects in the healthcare, energy and public sectors recovered significantly faster than standard project business in the fields of ERP (Enterprise Resource Planning), CRM (Customer Relationship Management) and SCM (Supply Chain Management).

Demand on the whole is continuing to change. Whereas customers used to demand telecommunications products and IT services as separate services, now they increasingly want one-stop ICT solutions to improve their corporate processes and raise their enterprise value. Cloud services, embedded systems, and intelligent networks in particular are increasingly transforming the market.

Regulatory influence on Deutsche Telekom's business.

Our business activities are largely subject to national and European regulation, combined with extensive powers to intervene in our product design and pricing.

We were again subject to extensive regulation in our **fixed-network business** in 2010. The main interventions are detailed in the following:

The Federal Network Agency issued two regulatory orders in the reporting period. On September 17, 2010, the Agency determined that the regulated wholesale service regime that applies to DSL will now generally also apply to VDSL and FTTH lines, as well as to Ethernet-based bitstream access. The standard offering must be adapted in line with the new order, with rates subject to ex-post control by the Federal Network Agency.

In September 2010, the Federal Network Agency issued a draft consultation paper for the regulatory order on unbundled local loop lines (ULLs). This essentially confirms the existing obligations for unbundled access to ULLs. The Federal Network Agency also intends to include pure fiber-optic access to ULLs in the existing regulatory regime on the basis of an ex-post obligation. With its appeal ruling in 2010, the Federal Administrative Court reimposed the obligation to grant access to dark fiber. The final regulatory order will be adopted following consultation with the European Commission.

The Federal Network Agency has also reviewed in ex-post proceedings the rates charged by us for the provision of customer data to providers of directory inquiry services and the publishers of telephone and business directories to determine whether they are abusive. On July 19, 2010, it ruled that any charges exceeding EUR 1.6 million per annum for the provision of data are abusive. We have initiated legal proceedings against this decision. Until a court ruling has been issued, this decision of the Federal Network Agency is binding.

On September 20, 2010, the European Commission issued its Recommendation on regulated access to Next-Generation Access Networks (NGA Recommendation) containing guidelines to be observed as far as possible by national regulatory authorities when obligating market-dominant companies to grant access to these networks. Its aim is to harmonize regulatory requirements in Europe. The object of the Recommendation is general regulation of access to the physical network infrastructure at the wholesale level and in the broadband access market. Overall, the European Commission is providing for price and access regulation that was developed for the existing copper network to be applied to new fiber-optic networks.

In spite of intense competition, mobile termination in the **mobile communications market** continued to be regulated ex-ante in 2010 and was thus subject to price control by the Federal Network Agency and the EU.

The next stage of the EU Roaming Regulation entered into force on July 1, 2010. Since then, outgoing calls within the EU cost 39 eurocents plus VAT and incoming calls cost 15 eurocents plus VAT. The inter-operator tariff (IOT) was reduced to 22 eurocents plus VAT. Prices for text messages sent or received remained unchanged at 11 eurocents and 4 eurocents respectively, plus VAT. For data roaming the IOT was reduced from EUR 1.00 to EUR 0.80. Also on July 1, 2010, a spending cap was introduced for all customers who did not expressly opt out. Now the data roaming connection is automatically interrupted once EUR 50 (net) are spent, until the customer actively confirms they want to continue using the connection and incur further costs. The future of the Roaming Regulation following the expiration of the current Regulation in July 2012 is currently being discussed in Brussels. In its Digital Agenda for Europe, the European Commission issued the political goal of abolishing the differences between national and roaming rates by 2015.

On November 30, 2010, the Federal Network Agency provisionally approved the new rates for call termination in national mobile networks that are applicable from December 1, 2010. This involved cutting Vodafone and Telekom Deutschland GmbH's previously asymmetric rates by around 50 percent, making them de facto symmetrical. The Federal Network Agency's rate ruling requires consultation throughout the EU and is expected to enter into force toward the end of the first quarter of 2011. These rates will expire on November 30, 2012.

Regulatory requirements for LTE roll-out. In May 2010, Telekom Deutschland GmbH purchased spectrum at auction in the 800 MHz, 1.8 GHz, and 2.6 GHz frequency ranges and by the end of October 2010 had received assignment notices from the Federal Network Agency for all frequencies purchased. The coverage requirements stipulate for the 800 MHz range that network operators must start rolling out LTE in towns and communities that have no or very little broadband coverage. Broadband coverage is to be increased to 90 percent of the population in these gaps by early 2016. Roll-out is to be in stages based on the number of inhabitants, beginning with municipalities with populations of 5,000 or less. Other broadband coverage provided by us or other operators (e.g., DSL or UMTS) with a minimum transfer bandwidth of 1 Mbit/s also count toward meeting the requirements. Irrespective of this, however, each network operator must provide 50 percent of the population with 800 MHz broadband services by the start of 2016.

There are also roll-out requirements for the new frequencies in the 1.8 GHz and 2.6 GHz spectrum ranges: 25 percent population coverage by the beginning of 2014 and 50 percent by the beginning of 2016. As GSM and UMTS also count toward these coverage targets, Telekom Deutschland GmbH has already met these requirements.